ECBC

EUROPEAN COVERED BOND **FACT BOOK**

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CRÉDIT FONCIER DE FRANCE
EMPRUNT FONCIER DE 500 MILLIONS
1913
Obligation de 500 Francs
No 363,334
Pfandbrief
FRANKFURTER HYPOTHEKENBANK
Eintausend Mark
FRANKFURTER HYPOTHEKENBANK
1000 Mark
BANCO HIPOTECARIO DE ESPAÑA
De 500 Pesetas 6%
BANQUE HYPOTHÉCAIRE D'ESPAGNE
De 500 Piecettes 6%
KREDITFORENINGEN DANMARK
300463

2015 ECBC EUROPEAN COVERED BOND **FACT BOOK**

ECBC
European Covered Bond Council

EUROPEAN MORTGAGE FEDERATION

This 10th edition of the ECBC European Covered Bond Fact Book builds on the success of previous editions, as the benchmark and the most comprehensive source of information on the asset class. Chapter I presents an analysis of ten key themes of the year, offering an overview of the Industry's views on these.

Chapter II provides a detailed explanation of covered bond fundamentals, including reviews of some of the current European regulatory changes that have had/are bound to have a direct, significant impact on covered bonds, mainly the Capital Requirements Directive and Regulation (CRD IV and CRR), Liquidity Coverage Ratio and Solvency II. This chapter also includes articles outlining the repo treatment of covered bonds by central banks, investigating the relationship between covered bonds and other asset classes such as senior unsecured and government bonds, and describing the USD & GBP denominated covered bond markets.

Chapter III presents an overview of the legislation and markets in 37 countries. Chapter IV sets out the rating agencies' covered bond methodologies and, finally, Chapter V provides a description of trends in the covered bond market as well as a complete set of covered bond statistics.

We welcome the broad range of views expressed in this latest edition of the Fact Book and we would like to extend our appreciation to the Chairmen of the ECBC "Fact Book" and "Statistics & Data" Working Groups, Mr Wolfgang Kälberer and Mr Florian Eichert respectively, as well as to all Fact Book contributors, whose efforts have once again produced an outstanding edition of the ECBC Fact Book.

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FOREWORD

Looking back over the last year, it is clear that the covered bond space has been fundamentally impacted by major waves of monetary policy, supervisory review and regulatory change. These developments and the new perspectives that they bring with them are reshaping market dynamics as well as the environment in which this asset class operates.

What's new?

In September 2014, the European Central Bank (ECB) announced the launch of the third covered bond purchase programme (CBPP3) alongside a first asset backed security purchase programme (ABSPP). This was closely followed in Q1 2015 by the public sector purchase programme (PSPP), complementing the existing private sector assets operation with one focused on government debt. The expansion, in both size and scope, of the ECB's monetary stimuli aims at propelling the Eurozone out of its current deflationary path. In fact, from a macroeconomic perspective, several European Union (EU) Member States entered into a period of deflation and recession. Moreover, for the first time, lenders and investors in some parts of the EU were faced with the unprecedented challenge of a negative interest rate environment.

At the beginning of November 2014, the new European Commission started its five-year term and the EU began a new chapter in the process of European integration. The Juncker Commission has set itself the ambitious political task of fostering growth whilst maintaining financial stability in 28 Member States, and is focussing its attention and actions on galvanising Europe against the risk of further recession and deflation by coordinating structural reforms, investment, and budgetary, fiscal and monetary policies. These initiatives will affect the lives of more than 500 million citizens. European Commission President, Jean-Claude Juncker, has announced a EUR 315 billion Investment Plan, which is intended to change how public money is used for investment in Europe. The Commission's subsequent call for the creation of a Capital Markets Union (CMU) has put the spotlight on the role of the banking sector in supporting the growth agenda and on the contents of the long-term financing toolkit at the disposal of stakeholders.

Looking at the process of European integration in more detail, an additional fundamental building-block was put in place on the 4th of November 2014 when the ECB fully assumed the supervisory tasks and responsibilities given to it in the framework of the Single Supervisory Mechanism (SSM), thereby taking charge of the euro area's 120 biggest credit institutions. This represents the biggest expansion of the ECB's powers since the introduction of the euro. The SSM, which is based in Frankfurt, will harmonise 19 sets of national supervisory practices aiming at a single pan-European framework, and oblige banks to take more precautions against crises.

The changes of recent months to the regulatory and policy environment in Europe are having a significant impact on the long-term financing and housing finance sectors. When considering how best to shape the future European banking landscape and build a capital markets union that will ensure the capability of the Industry to support the growth agenda and provide long-term financing to the real economy, several areas of reflection can be identified:

> 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 Basel Committee 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 small and medium sized enterprise (SME) financing, and lending to the real economy is becoming increasingly multi-faceted with the introduction of the Capital Markets Union.

> The role of covered bonds and the Industry's firm commitment to achieve a higher level of harmonisation, in line with EU objectives and market preferences.

The political perspective & the role of the ECBC

The path to the achievement of a common market offering free movement of goods, services, people and capital has been a long and gradual one. Starting in the 1950s with the signing of the Treaties of Paris and Rome, the process really started to take shape in 1985 with the initiative of the Delors Commission to design the Single European Act (SEA), and was developed further in the 1990s and 2000s with the signing of the Treaties of Maastricht, Amsterdam and Lisbon. Very much in line with the spirit of Delors, the Juncker Commission is revamping and extending what has gone before through its growth agenda and its plans to create deeper and more integrated capital markets in the 28 Member States by way of the CMU.

At present, after several years of financial crisis, the three dimensions of the European project – financial, political and economic – are converging in a "unicum", which is rapidly accelerating the process of European integration. However, this acceleration is also dramatically highlighting the frictions, lack of convergence and institutional gaps of the current European mechanisms.

This is where the financial services industry, which is a fundamental element of the European political and social landscape, can potentially play a crucial role in facilitating convergence and integration by enhancing transparency and market best practices. Furthermore, understanding the transmission channels that exist between the financial and other sectors of the economy is critical when assessing growth and financial stability. The latter is crucial as robust financial systems are viewed as those that do not adversely affect the system itself, and those that are capable of withstanding shocks and limiting disruption in the allocation of savings to profitable investment opportunities.

Thus far, politically, the financial services sector has acted as a scapegoat for the crisis, for market fragmentation and for political uncertainty. In this challenging political atmosphere, the European Institutions have initiated an overarching reform of the financial sector. In doing so, regulators have walked – and continue to walk – a difficult and dangerous path, in their quest to find a balance between harmonisation on the one hand and respect for national market traditions on the other, whilst at the same time limiting adverse collateral effects and ensuring social cohesion.

This new transition period raises expectations and emotions which have a much broader and deeper impact generally in the European society than ever before. The Industry is faced with the challenge of harnessing these new dynamics and contributing to the integration process by playing a proactive role in building the CMU so as to ensure financial stability and lending capacity, and to support economic growth, which remains at the heart of the European project.

Taking stock, it is clear that in only 12 months the European financial world has entered a completely new market and regulatory environment. In this context, the ECBC is now playing, more than ever, the role of market catalyst and think-tank, which is, in turn, allowing the market to converge and coordinate by speaking with one voice. Moreover, the role played by the ECBC in this new context ensures the smooth functioning of the market itself by identifying and implementing common qualitative standards and quantitative parameters. Looking ahead, the ECBC has the responsibility to continue to act as the Industry discussion forum and market "lighthouse", developing a clear vision of the challenges and opportunities on the horizon amongst market participants and, subsequently, guiding the Industry through these uncharted waters.

Regulatory recognition

Since the beginning of the financial crisis, around 30 pieces of financial regulation have been approved by the European Institutions, all aimed at strengthening the financial sector and rendering it more resilient to shocks. Amongst the most notable legislative proposals are: the Basel III framework for capital requirements; the framework for resolving banks (Bank Recovery and Resolution Directive – BRRD); the Banking Union; and the revamping of the European capital market structure. In particular, the implementation of the Capital Requirements Regulation (CRR) / Capital Requirements Directive (CRD) IV package in the EU is the backbone of the EU's Single Rulebook for banks, which aims at providing a single set of harmonised prudential rules that all financial institutions throughout the EU (approximately 8,300 banks) must comply with, thus helping complete the single market in financial services. SME and mortgage lending, key drivers of recovery in the real economy, are predominately based on bank lending principles that are rooted in the banking supervisory tradition, which thereby facilitates due diligence for investors and proper risk assessment. Looking at the numbers, roughly 85% of financing in the EU is provided by banks. The overall financial strength of the European economy is strongly correlated to banks' ability to lend to both the private and public sectors. This capacity has been impinged as a result of new global rules that require banks to increase their capital ratios.

The implementation of the Basel rules, together with the proper treatment of covered bonds and High Quality Securitisation, raises questions about how a level playing field can be ensured at the global level, especially for economies strongly reliant upon these funding instruments, such as in Europe. More importantly, as has been clearly indicated by their recognition in the ECB's Covered Bond Purchase Programme 3 and Asset Backed Securities Purchase Programme, these instruments play a pivotal role in the creation and development of a Capital Markets Union as key long-term financing tools and as a means for a common monetary policy to be effectively transmitted to the real economy.

This strong macro-prudential recognition was further confirmed by the publication of the Liquidity Coverage Ratio (LCR) delegated act by the European Commission in which covered bonds have been categorised as Extremely High Liquid Assets (Level 1). The ECBC welcomes the Commission's recognition of the macro prudential value of covered bonds. Indeed, the inclusion of covered bonds in Level 1 will facilitate the aim of delinking the sovereign from the banking sector.

A real economy long-term funding tool

Covered bonds represent a key funding tool for the future European banking industry. They are an effective way of channelling long-term financing for high quality assets at a reasonable cost. They improve banks' ability to borrow and lend over long-term horizons and, therefore, represent a stable source of funding for key banking functions such as housing loans and public infrastructure.

For instance, long-term financing is crucial for housing finance. Building or purchasing a home is the most significant investment for the majority of European citizens, representing typically four to five times their annual income. In the absence of pre-existing wealth, they would have to wait for 40 or 50 years if they had to rely solely on their individual savings. Borrowing resources are therefore necessary to acquire a home and more generally to support the European economy. Given the size of the investment, their repayment must be spread out over a long period to be compatible with their annual savings capacity. Long-term funding tools for banks are therefore required to avoid asset and liabilities mismatches. Covered bonds are typically designed for mortgage lending, and it is important to recall that a mortgage-focused bank tends to have more asset encumbrance than a bank with a non-mortgage focus. Cutting back lending capacities of those more specialised mortgage-focused banks would limit the credit supply to housing finance.

The efficient availability of mortgage finance is also based on the ready availability of financing at the longest tenors possible and the lowest price feasible. Without this, the mortgage market would be a function of market sentiment and the refinancing rates available to borrowers would be subject to much more price volatility, making planning for private households more challenging. In this context and in particular in times of low risk appetite from investors, covered bonds play an essential role in ensuring the flow of capital in financing long-term growth and the real economy. They offer key safety features such as a strict legal and supervisory framework, asset segregation, and a cover pool actively managed in order to maintain the quality of the collateral. During the recent financial turmoil, the existence of a well-functioning covered bond market has allowed governments in Europe to constantly channel private sector funds to housing markets and maintain a relatively efficient lending activity without increasing the burden for taxpayers and public debt.

The growth agenda debate has also dominated economic and political discussions beyond the EU, raising the key questions of how to finance economic growth and how to create an efficient and robust long-term financing toolkit. This debate has a very high political profile as it engages key stakeholders at both an international and a national level. Furthermore this raises fundamental questions regarding the fine-tuning of the Basel III parameters and the right calibration between enhanced risk assessments, reduction of systemic risks and continued lending capabilities of the banking sector. Such discussions belong, traditionally, to an emerging market landscape, where the World Bank has always played a pivotal role in assisting the development of capital market infrastructures which aim at ensuring economic growth and social development.

Looking at the numbers produced by the World Bank, 8.3 billion people are expected to be alive by 2030, with 60% of them living in cities. Consequently, the global demand for new dwellings is foreseen to rise by 565 million over the same period. Furthermore, the World Bank considers that in emerging markets, five permanent jobs are created for every new housing unit built, with the figure being even higher in the developed world, thus making housing a key driver for economic growth and social stability.

Market developments

Covered bonds are 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. Outside Europe, Australia, Canada, New Zealand and South Korea have already implemented covered bond legislation in recent years. Major jurisdictions including Brazil, Chile, India, Japan, Mexico, Morocco, Panama, Peru and the United States, are either in the process of adopting covered bond legislation or are investigating the introduction of covered bonds. This year's ECBC Fact Book provides comprehensive coverage of these new legislative frameworks and developments, and shows how the ECBC is further strengthening its role as the principal voice of covered bonds, not just in Europe but globally.

During the recent years of market turmoil, covered bonds demonstrated a strong degree of resilience. Throughout the crisis, they played a pivotal role in bank 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 the financial crisis while maintaining a focus on the essential features and qualities that have made the asset class such a success story. The ECBC firmly believes that the quality of the asset class will continue to be the basis of our strength in the future.

The success of covered bonds also lies in the Industry's capacity to respond to the challenges of the current crisis and its ability to share market best practices. This allows a continuous fine-tuning of European covered bond legislation and facilitates a strong level of transparency for the asset class. As indicated above, the instrument has enabled Member States in Europe to continue to channel private sector funds to housing markets and maintain efficient lending activity without an additional increase of burden for taxpayers or public debt. Furthermore, the on-balance sheet nature of covered bonds is an efficient and simple alternative to complex originate-to-distribute products ensuring financial stability.

The commitment to contribute to European efforts to enhance financial stability and transparency has led the covered bond industry to launch a quality Label. The Covered Bond Label was developed by the European issuer community 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 Label is based on the Covered Bond Label Convention, which defines the core characteristics required for a covered bond programme to qualify for the Label.

The Covered Bond Label and its transparency platform (www.coveredbondlabel.com) have been operational since 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 August 2015, 86 labels were granted to 74 issuers from 14 countries, covering over EUR 1.4 trillion of covered bonds outstanding.

In this context, covered bond issuers from these 14 different jurisdictions have come together to develop a Harmonised Transparency Template. From 2016 onwards (with a one year phase-in period), this will provide cover pool information in a harmonised format which allows for both the recognition of national specificities, with the National Transparency Tabs, and the comparability of information required to facilitate investors' due diligence.

The critical mass achieved by this initiative (c. 60% of covered bonds outstanding globally) is a clear sign that the Industry sees the need to respond to the requirements of new classes of investors by providing higher levels of transparency to aid investment decisions. Equally, it is important to highlight the progress that has been made in recent years in terms of collating and distributing relevant macro-level information on the covered bond sector:

> The ECBC website continues to be the primary site for aggregate covered bond market data and comparative framework analysis; and

> The ECBC Fact Book, now in its tenth edition, remains the most widely read source of covered bond market intelligence.

Looking ahead

In conclusion, the ECBC believes that the quality of the covered bond asset class will be the basis of our strength in the future. Over the last two centuries the asset class has made a significant contribution in Europe to supporting the real economy and ensuring financial stability. The Industry has demonstrated that through market initiatives such as the Covered Bond Label and the recently proposed European Secured Note (ESN), it is possible to build, from the bottom up, proposals based on market consensus in order to initiate pan-European solutions which enhance transparency, comparability, convergence of markets and best practices. Furthermore, it has been possible to do this without over-regulating and, thereby, potentially jeopardising the capabilities of lenders to support the growth agenda. More work needs to be done, but we believe that the initiatives underway will strengthen the asset class and facilitate the convergence of market and supervisory best practices. The increased recognition by policymakers and regulators of the central role that the asset class plays for the banking system and also for wider financial stability reinforces the need for an appropriate regulatory framework for covered bonds at both European and international levels. This will be our objective for the coming years.

Carsten Tirsbæk Madsen
ECBC Chairman

Luca Bertalot
EMF-ECBC Secretary General

ECBC
European Covered Bond Council

ABOUT THE ECBC

The European Covered Bond Council (ECBC) is the platform that brings together covered bond market participants including covered bond issuers, analysts, investment bankers, rating agencies and a wide range of interested stakeholders. The ECBC was created by the European Mortgage Federation (EMF) in 2004. As of August 2015, the Council has over 100 members across 25 covered bonds jurisdictions and many different market segments. ECBC members represent over 95% of covered bonds outstanding. The ECBC and the EMF re-integrated in 2014 under a common umbrella entity, the "Covered Bond & Mortgage Council". The intention is to further develop synergies, share market best practices, achieve convergence across the whole value chain of this Industry, and, at the same time, to act as a market catalyst in origination and funding techniques.

Against this background, the purpose of the ECBC is to represent and promote the interests of covered bond market participants at the international level. The ECBC's main objective is to be the point of reference for matters regarding the covered bond industry and operate as a think-tank, as well as a lobbying and networking platform for covered bond market participants.

ECBC STRUCTURE

The Plenary Meeting is a bi-annual discussion forum where all ECBC members gather around the table to discuss issues and to establish strong network links.

The Steering Committee, headed by the ECBC Chairman, and composed of representatives from the major covered bond issuing jurisdictions and industry experts, is responsible for the day-to-day activities of the ECBC. It comes together once every quarter and addresses strategy related questions. Furthermore, it coordinates the agenda of the various working groups.

ECBC WORKING GROUPS

> **The EU Legislation Working Group**, chaired by Mr Frank Will, has over the past years successfully lobbied at EU and international level to obtain special treatment for covered bonds. As well as monitoring and lobbying on the CRD IV/CRR, the European Legislation Working Group is actively working on issues such as Solvency II, OTC derivatives and crisis management.

> **The Technical Issues Working Group**, chaired by Mr Ralf Grossmann, represents the technical think thank of the covered bond community, drawing on experts from across the industry to tackle key issues for the industry. The Working Group tackles subjects relating to covered bonds such as the use and treatment of derivatives in the cover pool, bankruptcy remoteness and latest market developments. The Working Group manages and updates a database which provides an overview of covered bond frameworks across the EU and enables their features to be compared (this is accessible at www.ecbc.eu). The Working Group also operates as a tool of convergence to help national jurisdictions develop their respective National Transparency Templates (NTTs).

> **The Market Related Issues Working Group**, chaired by Mr Steffen Dahmer, discusses topics such as the MiFID review and conventions on trading standards and the market-making process. This Working Group is currently leading discussions on improving liquidity in secondary markets and, in the context of the MiFID review, on the issues of pre- and post-trade price transparency.

> **The Statistics and Data Working Group**, chaired by Mr Florian Eichert, is responsible for collecting and publishing complete and up-to-date information on issuing activities and volumes outstanding of covered bonds in all market segments. With over 29 different covered bond jurisdictions and numerous issuers, the collection of data is of utmost importance, particularly given that the ECBC data is increasingly viewed as the key source of covered bond statistics.

> **The Covered Bond Fact Book Working Group**, chaired by Mr Wolfgang Kälberer, is responsible for the publication of the annual ECBC Covered Bond Fact Book. This publication covers market developments, legislative frameworks in different countries and statistics.

> **The Rating Agency Approaches Working Group**, chaired by Mr Boudewijn Dierick, examines the rating approaches applied by rating agencies for covered bonds and, when necessary, convenes meetings and publishes position papers accordingly. The Working Group has also been monitoring the CRA III package.

Membership of the ECBC continues to grow and its agenda for the coming year is already filled with numerous activities. The ECBC's objective now is to press ahead in its work with a view to further strengthening its role in facilitating the communication amongst the different covered bonds stakeholders, in working as a catalyst in defining the common features that characterise the asset class and in facilitating improvements in market practices, transparency and liquidity.

More information is available from http://ecbc.hypo.org/

Luca Bertalot,
EMF-ECBC Secretary General

ECBC MEMBERS

ABECIP

ABN Amro

The Association of Banks in Singapore – ABS

Aktia Bank plc

Allen & Overy

Allied Irish Banks Plc. – AIB International Center

Asociación de Intermediarios de Activos – AIAF

Asociación Hipotecaria Española – AHE

Association of Danish Mortgage Banks – Realkreditrådet

Association of Hungarian Mortgage Banks – Magyar Jelzálogbank Egyesület

Association of Swedish Covered Bond Issuers – ASCB

AXA Bank Europe SCF

Banca Popolare di Milano – BPM

Bank of Ireland Mortgages Bank

Bankia

Banque Fédérale des Banques Populaires – BPCE

Barclays

Barclays Germany

Bayerische Landesbank – Bayern LB

Belfius Bank

Bloomberg LP

BNP Paribas

BNP Paribas Fortis

BRFKredit A/S

Caisse centrale Desjardins et Capital Desjardins inc.

Caisse Centrale du Crédit Immobilier de France – 3CIF

Caisse de Refinancement de l’Habitat – CRH

Caixa Geral de Depósitos S.A.

Canada Mortgage and Housing Corporation (CMHC)

Canadian Imperial Bank of Commerce (CIBC)

Citigroup Global Markets Germany

Clifford Chance LLP

Commerzbank Securities

Crédit Agricole Home Loan SFH – CM-CIC Home Loan SFH

Crédit Foncier de France

Crédit Mutuel – CIC Home Loan SFH

Crédit Mutuel Arkéa

Credit Suisse

CRIF

Danish Ship Finance

Danske Bank

DBRS Ratings Limited

Depfa ACS Bank

Deutsche Bank AG

DLR Kredit A/S

DnB Bolligkreditt

Dutch Banking Association of Covered Bond Issuers – DACB

DZ Bank

EAA Covered Bond Bank Plc.

Eika Boligkreditt AS

Eurex Bonds

Euromoney

EuroMTS

European AVM Alliance – EAA

European DataWarehouse GmbH

Finance Norway – FNO

Fitch Ratings Ltd

GOH Portugal

Goldman Sachs

Grupo BBVA

Gruppo Banca Carige

HSBC SFH Bank Plc.

Hypoport / Intertrust

ING Belgium

ING Group

Intesa Sanpaolo

Banking & Payments Federation Ireland –
BPFI / ACS Ireland

Italian Banking Association – Associazione Bancaria Italiana – ABI

JP Morgan

KBC Bank

Korea Housing Finance Corporation – KHFC

La Banque Postale Home Loan SFH

Landesbank Baden-Württemberg – LBBW

Linklaters Business Services

Lloyds Banking Group

Luxembourg Bankers' Association – ABBL

Merrill Lynch International

Moody's

Morgan Stanley Bank AG

National Bank of Greece SA – NBG

Nationwide Building Society

Natixis

NIBC Bank N.V.

Nomura International Plc.

Norddeutsche Landesbank Girozentrale

Nordea Hypotek

Novo Banco S.A.

Nykredit A/S

OP Mortgage Bank

pbb Deutsche Pfandbriefbank AG

Pfandbrief & Covered Bond Forum Austria

Pfandbriefbank schweizerischer Hypothekarinstitute

Realkredit Danmark A/S

Realkreditforeningen

Royal Bank of Canada – RBC

Royal Bank of Scotland – RBS

Santander UK Plc.

SEB AG

SNS Reaal Bank NV

Société de Financement Local

Société Générale Corporate & Investment Banking

Société Générale Société de Crédit Foncier – SG SCF

Standard & Poor's

Svenska Handelsbanken – Stadshypotek

TD Bank Group

TXS GmbH

UBI Banca

UBS

UK Regulated Covered Bond Council – UKRCBC

UniCredit Group

Verband Deutscher Pfandbriefbanken e.V. – vdp

White & Case

August 2015

COVERED BOND
· LABEL ·

COVERED BOND LABEL

The Covered Bond Label is a quality Label which responds to a market-wide request for common qualitative and quantitative standards and for an enhanced level of transparency and comparability in the European covered bond market. The Label:

> Establishes a clear perimeter for the asset class and highlights the core standards and quality of covered bonds;

> Increases transparency;

> Improves access to information for investors, regulators and other market participants;

> Has the additional objective of improving liquidity in covered bonds;

> Positions the covered bond asset class with respect to regulatory challenges (CRD IV/CRR, Solvency II, redesign of ECB repo rules, etc.).

The Covered Bond Label Foundation (CBLF) was founded by the EMF-ECBC in 2012 and it was developed by the European issuer community, working in close cooperation with investors and regulators, and in consultation with all major stakeholders. It became fully operational on the 1st of January 2013, with the first Labels being effective since then.

As of August 2015, visitors can find 14 National Transparency Templates, 74 issuer Profiles and information on 86 labelled cover pools with issuance data on over 4,000 covered bonds amounting to a total face value of over 1.4 trillion EUR.

The Label is based on the Covered Bond Label Convention (see below), which defines the core characteristics required for a covered bond programme to qualify for the Label. This definition of the required characteristics, which is updated on a yearly basis, is complemented by a transparency tool developed at national level based on the "Guidelines for National Transparency Templates".

The Covered Bond Label Foundation (CBLF) granted that the first Non-European Economic Area (non-EEA) Label in 2015. This was made possible following on from the decision taken in September 2014 to open up the Covered Bond Label Initiative, from the 1st of January 2015 onwards, to covered bond programmes beyond the frontiers of the EEA, provided that they comply with all the requirements of the 2015 Covered Bond Label Convention (see below).

The granting of the first non-EEA Label represents a significant achievement in terms of global convergence of market best practices, as well as in terms of enhancing transparency in the covered bond space. It is a particularly positive step for the market and especially for global investors, who will be able to perform their due diligence activities more easily and obtain issuers' data ranging from asset and liability side information to legislative details from different countries in a more comparable way.

2015 Covered Bond Label Convention

Covered bonds are debt securities, backed by mortgage, public sector or ship assets, and characterised by a twofold bondholders' protection mechanism rooted in a dedicated covered bond legal framework.

In more details:

I Legislation safeguards

a) The CB programme is embedded in a dedicated national CB legislation;

b) The bond is issued by -or bondholders otherwise have full recourse, direct or indirect[1], to- a credit institution which is subject to public regulation and supervision;

[1] Including pooling models consisting only of covered bonds issued by credit institutions.

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 CB product

a) Bondholders have a dual claim against:

i. The issuing credit institution as referred to in point I b);

ii. A cover pool of financial assets[2] (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 bondholders at all times.

c) Issuers are committed to providing regular information enabling investors to analyse the cover pool, following the guidelines developed at national level.

For further information on the Covered Bond Label Convention, visit www.coveredbondlabel.com

LABELLED COVER POOLS

AUSTRIA

UniCredit Bank Austria AG Credit Public Sector

UniCredit Bank Austria AG Credit Mortgage

DENMARK

BRFKredit a/s Capital Center E

Danish Ship Finance General Capital Center

Danske Bank A/S Cover Pool D – Denmark

Danske Bank A/S Cover Pool I – International

Danske Bank A/S Cover Pool C – Commercial

DLR Kredit A/S Capital Centre B

Nordea Kredit Realkreditaktieselskab A/S Capital Center 1

Nordea Kredit Realkreditaktieselskab A/S Capital Center 2

Nykredit Realkredit A/S Capital Centre E

Nykredit Realkredit A/S Capital Centre H

Realkredit Danmark A/S Capital Centre S

Realkredit Danmark A/S Capital Centre T

FINLAND

Danske Bank Plc Pool 1

Nordea Bank Finland cover pool

OP Mortgage Bank, Pool B

FRANCE

AXA Bank Europe SCF

BNP Paribas Home Loan SFH

BNP Paribas Public Sector SCF

BPCE Home Loan SFH

Caisse de Refinancement de l’Habitat

Caisse Française de Financement Local

Compagnie de Financement Foncier

Credit Agricole Home Loan SFH

Credit Agricole Public Sector SCF

Crédit Mutuel – CIC Home Loan SFH

Crédit Mutuel Arkéa Home Loans SFH

Crédit Mutuel Arkéa Public Sector SCF

HSBC SFH (France)

La Banque Postale Home Loan SFH

SG Credit Public Sector SCF

SG Credit Home Loan SFH

[2] The financial assets eligible for the cover pool (including substitution assets and derivative instruments) and their characteristics are defined in the national covered bond legislation which complies with the requirements of Article 52(4) of the UCITS Directive and Article 129 of the CRR, as well as those articles which specify its implementation, including a waiver for the requirement for the issuer to be based in the European Economic Area (EEA), allowing non-EEA LCR compliant covered bonds programmes to be eligible for the Label. Non-EEA Labels will be identified on the Covered Bond Label website in a different graphic solution to EEA Labels.

GERMANY

NORD/LB

UniCredit Bank AG HVB Mortgage

UniCredit Bank AG HVB Public

IRELAND

AIB Mortgage Bank ACS (Asset Covered Securities)

Bank of Ireland Mortgages ACS
(Asset Covered Securities)

ITALY

Banca Carige S.p.A. Credit Home/Commercial Loan

Cassa di Risparmio di Parma e Piacenza S.p.A – Cariparma OBG S.r.l.

Intesa Sanpaolo S.p.A. ISP CB Ipotecario S.r.l.

Intesa Sanpaolo S.p.A. ISP CB Pubblico S.r.l.

UniCredit S.p.A. BpC Mortgage s.r.l.

UniCredit S.p.A. OBG srl

NETHERLANDS

ABN AMRO Bank N.V. Cover Pool

F. van Lanschot Bankiers N.V. Conditional Pass-Through Covered Bond Programme

ING Bank N.V.

SNS Bank N.V. Cover pool

NIBC Bank N.V. Conditional Pass-Through Covered Bond Programme

NORWAY

DNB Boligkreditt AS mortgage cover pool

Eika Boligkreditt AS (EIKBOL)

Nordea Eiendomskreditt AS cover pool

SpareBank 1 Boligkreditt (Spabol)

PORTUGAL

Banco BPI S.A. Mortgage Cover Pool

Banco Comercial Português A.S. Residential Mortgages

Banco Santander Totta, S.A.

Caixa Económica Montepio Geral (CEMG)

Caixa Geral de Depósitos, S.A. Mortgage Cover Pool

Novo Banco, S.A. Mortgage Cover Pool

SINGAPORE

DBS Bank Limited USD10 billion Global Covered Bond

SPAIN

Banco de Sabadell, S.A.

Banco Popular Español S.A.

Banco Santander S.A. Mortgage Covered Bonds

Caixabank S.A. Mortgages Loans

CaixaBank S.A. Public Loans

Bankia Mortgage

Bankinter, S.A.

BBVA Covered Bond Programme

BBVA Public Sector Covered Bond Programme

Ibercaja Banco S.A.

Kutxabank S.A.

Unicaja Banco S.A. Mortgage Covered Bonds

SWEDEN

Länsförsäkringar Hypotek AB

Nordea Hypotek cover pool

SEB Cover Pool

Stadshypotek AB (publ) Swedish Pool

Stadshypotek AB (publ) Norwegian Pool

Swedbank Mortgage AB cover pool

The Swedish Covered Bond Corporation

UK

Abbey National Treasury Services plc

Clydesdale Bank PLC €10 billion Global Covered Bond Programme

Coventry Building Society – 1006

Lloyds Bank plc EUR60bn Global Covered Bond Programme

Nationwide Building Society Covered Bond LLP

Royal Bank of Scotland Covered Bond programme

Yorkshire Building Society Covered Bonds

CHAPTER 1 - KEY THEMES OF THE YEAR

1.1 COVERED BOND HARMONISATION: WHAT DOES IT MEAN?

We address in this article the two legs which are currently being discussed in terms of harmonisation in the covered bond market: (1) data disclosure and transparency and (2) legal frameworks.

1.1.1 HARMONISING TRANSPARENCY

By Anne Caris, Bank of America Merrill Lynch & Moderator of the ECBC Transparency Task Force

In the covered bond community, disclosure and transparency have been key topics in the spotlight in recent years. Following on from intense discussions and debates initiated in 2010 under the umbrella of the ECBC Technical Issues Working Group, aimed at the creation of the Covered Bond Label in 2012, the Covered Bond Investor Council (CBIC) outlined caveats with respect to data transparency and comparability. On 16 June 2015, the Covered Bond Label Foundation (CBLF) and the European Covered Bond Council (ECBC) announced the decision to implement a Common Harmonised Transparency Template across jurisdictions for all covered bond issuers that hold the Covered Bond Label. This will come into force in Q1 2016 and will be a binding requirement for the granting and renewal of the Covered Bond Label with a phase-in period of one year. Once fully implemented, it will have a direct impact on more than 70% of eligible covered bonds[1], which will have a worldwide impact, i.e. for c.60% of the covered bonds outstanding globally. Feedback from market participants and regulators has been positive and this initiative has been seen as an important step. But we ask, is it really?

ECBC'S TRANSPARENCY TASK FORCE (TTF)

In November 2014, the ECBC put together a task force to address transparency and harmonisation across the 13 National Transparency Templates (NTT)[2], which have been developed for its Covered Bond Label. While NTTs have contributed to enhanced reporting practices, they are heterogeneous and have not fully met market expectations. The TTF consists of 20 individuals from different countries and backgrounds (issuers, analysts, covered bond associations, data providers, etc.) organised around four work streams looking into: first, the investor side; second and third, the possibility of having a harmonised transparency template and one common glossary; and fourth, exploring the future development of a common IT platform. The TTF's approach has been pragmatic, keeping in mind the costs and benefits for the industry as a whole. The existence of national differences has also been confirmed throughout the project, preventing full harmonisation, but which can be explained in a separate glossary to safeguard transparency (a Harmonised Glossary (HG)). We highlight thereafter the key outcomes from the TTF regarding harmonising data disclosure and further enhancing transparency in the covered bond market.

INVESTOR NEEDS AND WISHES: WHAT EXACTLY?

"Work Stream I" surveyed a range of European covered bond investors to understand where we are in terms of data transparency versus their needs. While welcoming the work conducted under the Covered Bond Label, they could still see further room for improvement, especially in terms of usability, comparability and timeliness. Investors' main criticisms were as follows:

> Data is not comparable across countries, with still major discrepancies;

> It is often reported without further clarifications; and

> The format is hard to use.

In the Nordic region, investors highlighted, however, the importance of qualitative input from the issuers and the need to trust their management/investor relation teams. Another major point was that harmonisation should not be at the expense of national features.

[1] That is Capital Requirements Regulation (CRR) compliant covered bonds.

[2] Singapore NTT was released afterwards, at the end of June 2015.

CBIC has not stood still since 2012 and actually published a report in August 2014 outlining the next stage for investors regarding cover pool transparency and recommending the following actions:

> Support a single central data repository for information on cover pools;

> Refine investors' data needs particularly for structural features that are not readily available, for example more details of swap arrangements impacting the cover pool; and

> Promote, through further disclosure in line with the recommendations of the CBIC templates, greater transparency in covered bonds at national and European level. It has also looked into further improvements since then to reflect recent developments in the covered bond market, for example, in terms of maturity structures as soft-bullet or conditional pass-through structures take off.

Ultimately, investors' needs and wish list regarding disclosure from the TTF survey were as follows, addressing contents and functionalities:

> Harmonised data in a more user-friendly downloadable format (i.e., available in Excel).

> Harmonised definitions by issuers – ideally across jurisdictions and, if not possible, at least within a jurisdiction (definitions should be disclosed).

> No loan by loan data which was only required, and is used, by a small minority of investors, with the availability of historical series being seen as more important.

> Harmonised timing as issuers should disclose relatively recent data and a central location where investors can download reports.

> Disclosure of key details such as regulatory treatment, maturity structures, counterparties involved, rating triggers, levels of committed over-collateralisation and covered bond structures.

A HARMONISED TRANSPARENCY TEMPLATE (HTT)

"Work Stream II" looked into how to harmonise the current 13 NTTs and meet investors' and other market participants' needs. This was done simply by mapping the NTTs and comparing all the reported items. The exercise showed many similarities but also potential for higher data harmonisation, even though a one-size-fits-all approach was clearly not achievable due to national differences driven by, for example, the housing market or the covered bond legal framework. On this basis, the TTF suggested an HTT allowing for flexibility and taking into account where harmonisation was possible or not. The HTT consists of three sections with general information and specific details on both mortgage and public sector assets, whichever is relevant for the covered bond programme. It will be reported at least on a quarterly basis.

A number of items were actively discussed mirroring reporting differences often driven by national requirements. These notably consisted of:

> Net present values (NPV) for outstanding covered bonds and cover assets, which are required only in a few covered bond legislations;

> Data related to currency and interest rate risks, including hedging and derivatives;

> Over-collateralisation, which can differ by nature and have several purposes (e.g., legal minimum, rating commitment, actual);

> Unindexed and indexed loan-to-values (LTVs) by property type; and

> Data disclosure based on balances, but also on the number of loans to provide information on the granularity of the cover pool.

Investor wishes that were refused for specific reasons include the following:

- Detailed information on the counterparties involved in the structure for confidentiality purposes;
- Rating triggers and issuer or covered bond ratings to reduce rating reliance, while rating information might be obsolete and misleading between two reporting dates; and
- The structure of the covered bond programme, as the details of particular set-ups may require more than a few words to explain and outline their implications. However, these details may be reported separately if seen as relevant at a jurisdiction and/or issuer level.

A HARMONISED GLOSSARY (HG)

"Work Stream III" provided the second significant leg to improve transparency – that is the HG. While market participants understand that a one-size-fits-all approach is not possible, differences in definitions need to be explained, which is not always the case under the current 13 NTTs. The TTF findings showed material discrepancies in terms of content and/or format when a glossary is available. Therefore, the main objectives of the HG have been to:

- Ensure disclosure across countries;
- Harmonise template and format for simplicity and comparability;
- Explain key underlying data and calculations rather than abbreviations (e.g., LTVs); and
- Reflect national differences where relevant.

To provide flexibility and allow for national and/or issuer differences, the HG is an appendix to the HTT and is designed as follows:

- A list of key common terms to be explained on an issuer basis across all countries.
- Definitions should reflect national characteristics.
- Each country and/or issuer can mention further terms besides those commonly explained terms as relevant in a separate section.

Terms to be commonly explained are OC calculation (actual, legal minimum, committed); interest rate types; maturity buckets of cover assets and covered bonds; LTVs (i.e., definition, calculation of property value, applied property valuation techniques, frequency and time of last valuation); explain how mortgage types are defined; hedging strategy; non-performing loans; NPV assumptions (if relevant). As mentioned above, these may be supplemented by optional national and/or issuer items.

WHAT ABOUT A COMMON IT PLATFORM?

"Work Stream IV" investigated the possible avenues for a common IT database. Central access to the HTT and HG was highlighted as "nice to have" by investors although not a "must-have" with the HTT/HG in e- and timeliness format being the market priorities. The work undertaken ended with more questions than answers. Who will run the platform? Who will access it? How could it be financed? Furthermore, key challenges were identified across countries and issuers, for example, in terms of data responsibilities and ownership.

As a result, the TTF decided to continue to use the existing IT structure which provides a link to the NTTs via the Covered Bond Label website, which is regarded as suitable in the meantime and provides a central starting point, which is what matters the most to market participants for now. The enhancement of the Covered Bond Label website with the introduction of new analytical functions is also planned. But a common IT platform is seen as a medium-term project, which requires a step-by-step approach given the related challenges.

SO TRANSPARENCY: WHERE DO WE STAND?

Feedback on the industry commitment to enhance data transparency and comparability has been positive so far. As outlined in the ECBC Press Release from 16 June 2015, the CBIC stated that "after years of intense and constructive dialogue between issuers and investors, the Common Harmonised Transparency Template represents a welcome and significant step forward, which will facilitate data comparability and investors' due diligence, thereby contributing to building the Capital Markets Union". Implementation across countries and issuers during 2016 will be another major milestone.

1.1.2 CONVERGING LEGAL FRAMEWORKS

By Joost Beaumont, ABN AMRO BANK N.V.

COVERED BOND FRAMEWORKS NEED TO CONVERGE ACCORDING TO EUROPEAN BANKING AUTHORITY (EBA)

The question is whether we will see some convergence in legislative covered bond frameworks. According to the EBA recommendations, it is vital that covered bond legislation be improved on an ongoing basis, preferably along the lines of its best practices. The EBA noted that more convergence is needed to increase safety and robustness of the covered bond instrument, while it will also strengthen the EU covered bond market more generally. In the end, this will support financial stability as well. The EBA has identified a number of key areas that determine the strength of covered bond frameworks, and for which it has recommended best practices. The key areas that need convergence in the medium to longer term are:

> Dual recourse mechanism;

> Segregation of cover assets and bankruptcy remoteness of covered bonds;

> Cover pool features;

> Valuation of cover assets and LTV limits as well as other requirements on mortgage cover assets;

> Coverage principle and legal over-collateralisation;

> Asset and liability risk management;

> Covered bond monitoring;

> Role of supervisor;

> Investor reporting.

MORE URGENT ACTION NEEDED TO KEEP PREFERENTIAL RISK-WEIGHT

Furthermore, the EBA mentioned that additional requirements are needed in order for covered bonds to keep qualifying for a preferential risk weight treatment. The EBA has said that the preferential risk weight treatment of covered bonds is justified, but it has also recommended the European Commission to add some specified conditions to Article 129 of the CRR. The recommendations are mainly targeted to increase investor protection (or the safety of covered bonds), rather than about the eligibility of asset classes (which Article 129 is mainly about), reflecting that the EBA sees room for improvement in this respect. These four key focus areas need to be dealt with in the near to medium term in order to continue to justify the favourable risk weight treatment of covered bonds. Those are:

(1) Minimum level of legal/regulatory OC, which should take into account the different ways that OC is currently calculated across jurisdictions. This relates to key areas four and five.

(2) Introduction of liquidity buffers. In this case, the difference between covered bond structures (i.e. hard bullet, soft bullet, and conditional pass-through) should be taken into account, as the extent of liquidity risk differs between them. This relates to item six.

(3) The role of the special public supervisory authority should become clearer. More specifically, the role prior to the issuance of covered bonds, that on a going concern basis, as well as the role following a default of the issuer should be better specified. Hence, this addresses key area number seven and eight.

(4) Reporting requirements should be broadened in order to increase transparency. This recommendation is related to key area nine.

Most of the recommendations are already incorporated in covered bond legislation in EU countries, but in most cases this is done in different ways, resulting in a fragmented market. Italy, Sweden and Norway, have for instance not set a specific OC target besides that it should be positive. Furthermore, many countries have implemented that liquid assets need to be available at any time to cover interest (and principal) payments over the next 180 days (e.g. Belgium, the Netherlands, Germany, France), but other countries have different rules to limit liquidity risk. Meanwhile, the calculation of OC differs between countries, as some refer to the nominal level of OC, while other estimate it on a (stressed) net present value basis. Finally, in a majority of jurisdictions, covered bond supervision goes beyond that of normal supervision of credit institutions according to the EBA. Nevertheless, it favours that legal frameworks specify more clearly the tasks and powers of national supervisors, given the complex nature of covered bond (programmes). All these measures have the aim to increase investor protections.

DUTCH EXAMPLE

Now that the EBA has published its recommendations, it will be interesting to see whether countries indeed incorporate the proposals into their covered bond frameworks. The update of the Dutch covered bond law as of 1 January 2015 provides a good example. The old framework dated from 2008, and was mainly principle based. So, it was clear that amendments were needed to keep the framework up to date. During the drafting of the new law, the EBA published its best practices, which were subsequently taken on board by the regulators. In the end, the law has become more rule-based, while the four key focus areas of the EBA have also been incorporated in the law.

For starters, the legal basis of the framework will be incorporated into the Dutch law, whereas previously it was only incorporated into lower regulation. This will give the regulators more power to intervene, strengthening the framework from a legal perspective. This change is in line with the proposal to make the role of the competent authorities clearer. Related to this, covered bond issuers also need to provide the regulator with documentation about the operational process following a default, providing more post-default safeguards. This documentation will not be made public, but at least it forces issuers to specify the procedure after a default, after which the regulator can provide some input. As a result, institutions/countries are better prepared for any default.

Key focus areas one and two have also been adopted in the new Dutch law by including a mandatory OC level as well as liquidity buffers. The new law demands a minimum OC level of 5% on a nominal basis, which compares to a ‘greater than zero’ requirement in the old framework. Requirements on liquidity buffers have also been incorporated in the framework, although this depends on the structure of the covered bond. Liquidity buffers need to cover interest payments, principal, and other (administrative) costs, that will be due in the coming six months, but in case of soft bullet structures with an extension period of six months or more as well as conditional pass-through structures, no upcoming principal payments need to be included in the buffer.

Another important change related to the best practices (but not the key focus areas) is that Dutch covered bond issuers need to specify the collateral in the cover pool at the time of registration. Public loans, residential mortgages, commercial mortgages, and shipping loans, all qualify as cover assets. Furthermore, only a mix of residential and commercial mortgages might be included in the same cover pool, but only under the condition that the issuer specifies (and keeps) a fixed ratio between both types of assets. The will improve transparency.

Overall, the changes to the Dutch law have brought the framework into line with the best practices as proposed by the EBA. As such, the Dutch law update can serve as a model for other jurisdictions how to align the framework with the EBA best practices. This would, in turn, automatically result in further convergence of legal frameworks across the EU.

SPAIN NEXT IN LINE

Spain is next in line and has already made quite some progress in adopting a new covered bond law. The competent authorities have already indicated that they will also stay close to the EBA's best practices recommendations. The authorities have identified some main areas of improvement of which the following relate to the best practices:

- Clarification of the rights of the covered bond holders in case of insolvency;
- Indexation of the value of cover pool assets;
- Redefinition of the eligible assets for each type of covered bond;
- Additional liquidity management measures;
- More complete, transparent and homogeneous information;
- Create supervisor to monitor asset pool.

The final draft was not yet available at the time of writing, but also in the case of Spain, it seems that authorities want to adhere to the standards set out by the EBA. Also in this case, it would result in convergence of the Spanish law with that in other jurisdictions. More generally, it is likely that jurisdictions will use the best practices proposals as benchmark when revising covered bond frameworks.

SO CONVERGENCE: WHAT DOES IT MEAN?

Looking forward, covered bond frameworks are likely to converge along the lines of the EBA best practices, which in the end will increase investor protection. At least, investors will have access to more (detailed) and up to date information, which will support them in their portfolio analysis. Furthermore, it would be good to know more about the role of the special public supervisory authorities, although it still remains to be seen how authorities will actually respond when there is a real test case. Despite expected further convergence, covered bond frameworks will continue to show differences. This is not necessarily a bad thing and often reflects national specificities (e.g. legal, housing). Indeed, despite the differences, the covered bond market has so far functioned rather well, also because it offers room for diversification. In the end, harmonisation/strengthening covered bond frameworks is good, but it is no panacea.

1.2 COVERED BOND PURCHASE PROGRAMME 3: RAMIFICATIONS ACROSS PRIMARY AND SECONDARY MARKETS

By Matthias Melms, Nord/LB, Franz Rudolf, UniCredit and Maureen Schuller, ING Bank

COVERED BOND PURCHASE PROGRAMME 3 – THE FACTS

On Thursday, 4 September 2014, the European Central Bank (ECB) announced its plan to buy covered bonds. This new Covered Bond Purchase Programme (CBPP) came as a surprise to markets and was the third covered bond purchase programme besides the CBPP1 (from July 2009 to June 2010) and the CBPP2 (from November 2011 to October 2012). Purchases of the CBPP3 started at the end of October 2014 and will continue for two years. The ECB's rational was that alongside the Asset-Backed Securities Purchase Programme (ABSPP) and the Targeted Longer-Term Refinancing Operations (TLTROs), the CBPP3 will further enhance the transmission of monetary policy, facilitate credit provision to the euro area economy, generate positive spill-overs to other markets and, as a result, ease the ECB's monetary policy stance, and contribute to a return of inflation rates to levels closer to 2%.

The purchases are conducted in both primary and secondary markets in a uniform and decentralised manner, meaning that the Eurosystem central banks purchase eligible covered bonds from eligible counterparties.

In order to qualify for purchase under the programme, covered bonds must fulfil the following eligibility criteria:

> Be eligible for monetary policy operations in line with section 6.2.1 of Annex I to Guideline ECB/2011/14 (eligibility criteria for marketable assets) and, in addition, fulfil the conditions for their acceptance as own-used collateral as laid out in section 6.2.3.2. (fifth paragraph) of Annex I to Guideline ECB/2011/14.

> Be issued by euro area credit institutions; or, in the case of multi-cédulas, by special purpose vehicles incorporated in the euro area.

> Be denominated in euro and held and settled in the euro area.

> Have underlying assets that include exposure to private and/or public entities.

> Have a minimum first-best credit assessment of credit quality step 3 (CQS3; BBB- or equivalent) by at least one rating agency.

> For covered bond programmes which currently do not achieve the CQS3 rating in Cyprus and Greece, a minimum asset rating at the level of the maximum achievable covered bond rating defined for the jurisdiction will be required for as long as the Eurosystem's minimum credit quality threshold is not applied in the collateral eligibility requirements for marketable debt instruments issued or guaranteed by the Greek or Cypriot governments, with the following additional risk mitigants: (i) monthly reporting of the pool and asset characteristics; (ii) minimum committed overcollateralisation of 25%; (iii) currency hedges with at least BBB- rated counterparties for non-euro-denominated claims included in the cover pool of the programme or, alternatively, that at least 95% of the assets are denominated in euro; and (iv) claims must be against debtors domiciled in the euro area.

> Covered bonds issued by entities suspended from Eurosystem credit operations are excluded for the duration of the suspension.

> Counterparties eligible to participate in CBPP3 are those counterparties that are eligible for the Eurosystem's monetary policy operations, together with any of the counterparties that are used by the Eurosystem for the investment of its euro-denominated portfolios.

> The Eurosystem will apply an issue share limit of 70% per ISIN (joint holdings under CBPP1, CBPP2 and CBPP3), except in the case of covered bonds issued by issuers in Greece and Cyprus and not fulfilling the CQS3 rating requirement; for such covered bonds, an issue share limit of 30% per ISIN will be applied.

> Covered bonds retained by their issuer shall be eligible for purchases under the CBPP3, provided that they fulfil the eligibility criteria as specified.

Furthermore, the Governing Council has decided to make its CBPP3 portfolio available for lending. Lending will be voluntary and conducted through security lending facilities offered by central securities depositories, or via matched repo transactions with the same set of eligible counterparties as for CBPP3 purchases.

Compared to the CBPP1 and CBPP2, the current purchase programme (CBPP3) did not apply any minimum size or any specific maturity of the covered bonds purchased.

PREVIOUS COVERED BOND PURCHASE PROGRAMMES

In June 2009, the ECB had announced its first Covered Bond Purchase Programme (CBPP1) with a volume of EUR 60 bn – with purchases between July 2009 and June 2010. The programme was fully used with a nominal value of EUR 60 bn, and, in total, 422 different bonds were purchased, 27% in the primary market and 73% in the secondary market. The Eurosystem mainly purchased covered bonds with maturities of three to seven years, which resulted in an average modified duration of 4.12 for the portfolio as of June 2010. In November 2011, the ECB launched its second Covered Bond Purchase Programme (CBPP2) with a programme size of EUR 40 bn and eligible covered bonds to be purchased up until October 2012. However, cumulative purchases reached only a volume of EUR 16.4 bn, of which 36.7% related to the primary market and 63.3% to secondary markets.

> FIGURE 1: KEY CBPP ELIGIBILITY CRITERIA IN COMPARISON

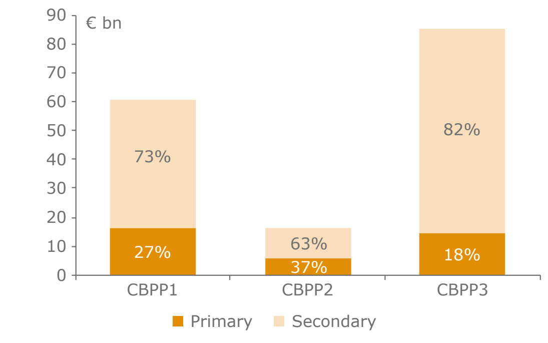
	CBPP1	CBPP2	CBPP3
Programme size	EUR 60 bn	EUR 40 bn	Not specified
Purchase period	7/2009 to 6/2010	11/2011 to 10/2012	10/2014 to 9/2016
Amount purchased	EUR 60 bn	EUR 16.4 bn	Still ongoing
Bond size	EUR 500mn or above as a rule and in any case not lower than EUR 100mn	EUR 300mn or above	Not specified
Minimum rating	AA as a rule and in any case not lower than BBB-	BBB-	BBB- (special criteria for Cyprus and Greece)
Residual maturity	Not specified but focus on 3Y-7Y	Maximum 10.5Y	Not specified
Underlying assets	Exposure to private and/or public entities	Exposure to private and/or public entities	Exposure to private and/or public entities
Retained issues	Not eligible	Not eligible	Eligible
Limit per ISIN	Not specified	Not specified	70% joint limit of CBPP 1, 2 and 3

Source: ECB, UniCredit Research

PRIMARY AND SECONDARY MARKET PURCHASES

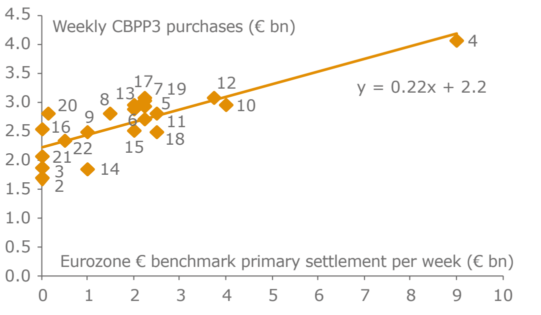
The share of primary market purchases of covered bonds by the CBPP3 has proved less pronounced compared to the previous two covered bond purchase programmes. Up until the end of May 2015, the total primary percentage amounted to just below 20% of the covered bonds purchased. As discussed in the previous paragraph, this compares with primary shares of 27% and 37% respectively under the CBPP1 and CBPP2. However, the overwhelming purchase pace at the onset of the third purchase initiative and rapidly tightening spread levels since its announcement, proved difficult to digest by the primary market as early as late 2014. Some deals struggled to find sufficient investor interest and faced market reluctance to accept ever more expensive pricing levels, as distribution statistics confirmed occasional allocations in excess of 50% to the traditional central bank and SSA (sovereigns, supranationals and agencies) investor base. It was not until the ECB decided to modestly slow its purchase pace to avoid further disruptive effects, while announcing its public sector purchase intentions, before primary market circumstances improved again.

> Figure 2: CBPP primary and secondary market purchases



Source: ECB, ING Bank

> Figure 3: Supply explains weekly purchase variations



Source: ECB, ING Bank

Year-to-date the weekly purchases have been relatively stable within the EUR 2.5 bn to EUR 3 bn range, even after the start of the Public Sector Purchase Programme (PSPP) in mid-March 2015. This compares with purchases mostly within the EUR 3 bn to EUR 4 bn range in the fourth quarter of last year. To illustrate the ECB's weekly primary versus secondary purchase pattern in these periods, Figure 3 depicts the weekly purchases under the CBPP3 against the eurozone EUR benchmark primary settlement per week in a scatter plot diagram for the first 22 weeks of this year. The scatter plot data labels reflect the week of settlement. The figure illustrates that weekly purchase variations are strongly correlated with variations in primary (settlement) activity. As a rough rule of thumb, central banks participated for 22% in the eurozone EUR benchmark covered bond debt printed per week this year, augmented by a further EUR 2.2 bn in the secondary market.

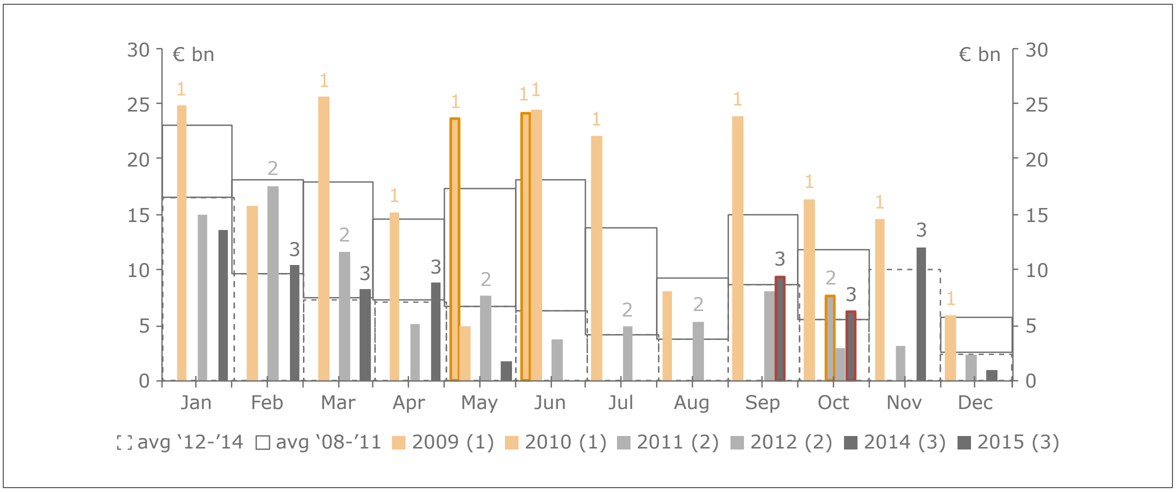
A similar scatter plot analysis of weekly purchases for the fourth quarter of last year (not plotted here) points at an initial purchase pace of EUR 2.7 bn per week in secondary markets topped up with 29% of the weekly EUR benchmark primary settlements. This confirms that central bank purchases were not only scaled down in primary markets, but also in secondary markets.

CBPP RELATED SUPPLY DYNAMICS

Figure 4 assesses the covered bond supply effect of the CBPP3 in comparison to the two antecedent covered bond purchase programmes. To adjust for monthly seasonality in supply, we compare the monthly issuance immediately after the announcement of (as reflected by the bars with orange border lines) and during the term of the three purchase programmes with the typical monthly supply average for a specific month.

Due to the significant drop in covered bond supply since 2012, related to the generally lower bank funding need and declines in bank balance sheets, we compare the monthly supply during the CBPP2 and CBPP3 with the average monthly supply in the period 2012-2014, while we measure the monthly supply during the CBPP1 against the average monthly supply numbers during the period 2008-2011. To make the number of months in which supply exceeded the monthly average reference level more obvious, we labelled the bars with above average supply as "1" (during the course of the CBPP1), "2" (during the course of the CBPP2) or "3" (during the course of the CBPP3).

> FIGURE 4: ASSESSING THE SUPPLY EFFECT OF THE COVERED BOND PURCHASE PROGRAMMES



Source: Dealogic, ING Bank

The figure indicates that the announcement of the CBPP3 in September 2014 had a positive effect on primary activity. However, the actual start of the purchase programme towards the end of October 2014, saw an even stronger positive effect on the November 2014 supply numbers as, among others, several southern European banks took the opportunity to print new covered bond instruments. The figure also confirms the more difficult primary conditions and relatively subdued supply in December 2014 and even in January this year. From February to April 2015, i.e. after the ECB's announcement on 22 January 2015 to expand its asset purchase programme perimeter, and the start of the PSPP on 9 March 2015, covered bond supply exceeded the monthly average again every single month.

One conclusion drawn from this, irrespective of the repercussions of the CBPP3 on returns and investor demand, is that the impact of the CBPP3 on supply has, in any event, been more favourable than in the case of the CBPP2. In the month of the announcement of the CBPP2 in October 2011 and subsequently, during the twelve month term of the CBPP2, supply was above average in six out of thirteen months (46%). Since the announcement of the CBPP3, 67% of the months saw above average supply activity in covered bonds.

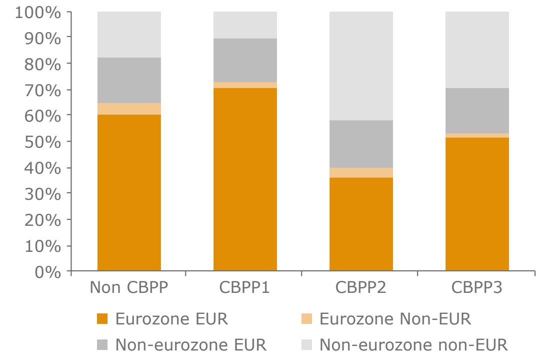
That said, as a positive driver for covered bond supply, the CBPP1 remains the most supportive programme. Since the announcement of the CBPP1 in May 2009 and during the term of the programme from the beginning of July 2009 until the end of June 2010, supply exceeded the 2008-2011 average in eleven out of fourteen months (79% of the months).

DEMAND FOR YIELD SUPPORTS NON-EURO AND LONGER MATURITY PRIMARY FOCUS

The supportiveness of the CBPP1 with regard to eurozone covered bond supply, as compared with the CBPP2 and CBPP3, is also confirmed by Figure 5. This figure gives an overview of the share of eurozone and non-eurozone issuance in the period from January 2008 to May 2015, during the term of the three different purchase programmes and in the months not influenced by these programmes. The figure confirms the higher share of EUR issuance by eurozone banks during the term of the CBPP1.

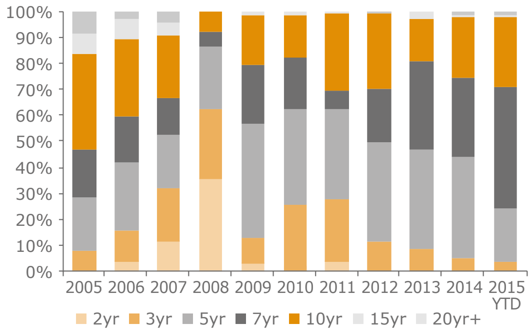
Counterintuitively, the increasing share of non-eurozone supply during the terms of the CBPP2 and CBPP3 suggests that these two programmes have been more supportive to the covered bond supply of non-eurozone issuers than to the supply from eurozone banks. In our view, this confirms the positive spill over effects for non-eurozone issuers as a result of forced and/or voluntary return driven investor reallocations to non-CBPP eligible alternatives as a consequence of the increased central bank demand for eurozone covered bonds.

> Figure 5: Primary activity distribution by currency



Source: Dealogic, ING Bank

> Figure 6: EUR benchmark maturity focus



Source: ING Bank

Furthermore, irrespective of this year's increasing interest of covered bond issuers in non-EUR covered bond deals, Figure 5 suggests that the central bank purchase initiatives typically do coincide with a relatively stronger focus by eurozone issuers on printing EUR-denominated trades. That said, even within the eurozone issuers from markets most affected by the low or negative yields have refocused on covered bond funding outside the EUR market, as a means to meet increased investor demand for non-EUR bonds.

As a final implication of the CBPP3 on supply we refer to Figure 6. This graphic illustrates the supply effects in terms of maturity of the enlarged focus of investors on higher coupon alternatives. Historically speaking, the supply focus by issuers on the 7yr maturity zone and beyond has in the past ten years never been higher than it is this year.

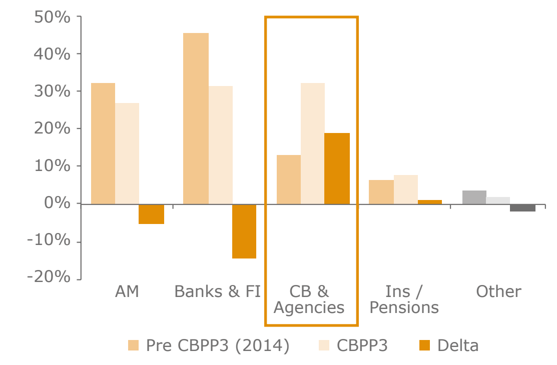
ASSESSING THE CROWDING OUT EFFECT OF CBBP3 IN PRIMARY MARKETS

Regardless of the low 19% share of primary purchases under the CBPP3, primary market distribution characteristics do provide valuable insights into the purchase focus areas as well as the impact on demand from other investors.

To start with a discussion of the latter, Figure 7 gives an overview of the distribution statistics by investor type of EUR benchmark covered bonds issued by eurozone issuers in 2014 and 2015 YTD, comparing allocations ahead of the CBPP3 and after the start of the CBPP3. The figure confirms that the allocation of primary covered bond transactions to central banks and agencies has risen by 19 percentage points since the start of the CBPP3. The higher portion allotted to central banks has mainly come at the expense of allocations to banks and, to a lesser extent, asset managers. Demand from insurers and pension funds has been less affected.

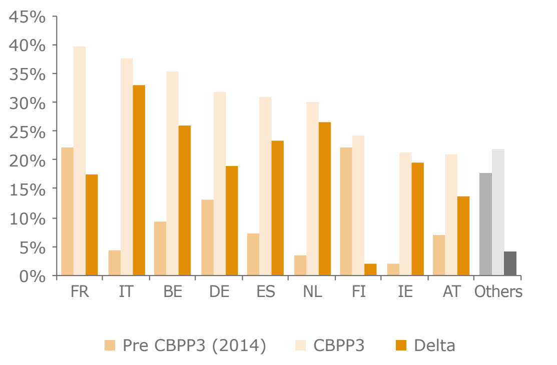
This can partly be explained by the increase of longer maturity issuance since the beginning of the CBPP3. Insurers and pension funds typically focus more on longer maturity bonds while bank investors tend to participate more in shorter maturity covered bond transactions. However, an analysis of primary distribution statistics by maturity buckets (not plotted here) suggests that allocations to central banks have seen the strongest increase in the 10yr maturity bucket by 25 full percentage points to 33%. In the 5yr area allocations to central banks increased only by 11 percentage points to 29%. Hence, since the beginning of the CBPP3 central bank participation in primary deals has been more evenly distributed across the different maturity buckets than before the programme was in force, when a stronger front-end focus was evident.

> Figure 7: Primary participation by investor type



Source: IGM, ING Bank

> Figure 8: Central bank participation per jurisdiction



Source: IGM, ING Bank

Figure 8 offers an overview of primary allocations to central banks and SSAs per jurisdiction. The figure confirms the strong rise in primary allocations to central banks of covered bonds issued by eurozone issuers, compared to deals printed by non-eurozone issuers (the grey bars in the chart). Furthermore, eurozone jurisdictions such as Spain and Italy that traditionally tend to benefit less from central bank demand, appear to benefit more from the increased central bank demand on the back of the CBPP3 than core jurisdictions such as Germany, France or Finland. Another interesting development is that also non-eurozone covered bond markets observed a modest increase in allocations to central banks. This, in our view, indicates a reallocation of the traditional (non-CBPP3 driven) central bank demand to the "enhanced yielding" non-eurozone covered bond alternatives.

IMPACT OF CBPP3 ON SECONDARY MARKETS

Mario Draghi's announcement at the start of September 2014 that covered bonds would also be included in the quantitative easing programme of the ECB, under the CBPP3), not only impacted primary markets. It also resulted in a significant spread movement in the secondary markets. This is an analysis of how different covered bond segments have responded to the purchase programme in secondary markets in the period from 1 September 2014 to 31 May 2015. We will also assess whether an excess return could be achieved by covered bonds on the capital market in comparison with other segments on the capital market.

Following the index adjustment of the iBoxx Euro Covered, at the end of May 2015, the index comprised a total of 645 bonds with an outstanding volume of EUR 732.9 bn. It is our understanding that 491 bonds qualify for the CBPP3, with a cumulative volume of EUR 555 bn. Consequently, 75.3% of the outstanding volume in the iBoxx Euro Covered fulfils the criteria of the purchase programme. As at the reporting date of 29 May 2015, the ECB had purchased a total bond volume of EUR 85,108 m on the primary and secondary markets. To gain an indication of the proportion of the CBPP3 purchase volume that is so far accounted by benchmark issues, which are therefore included in this index, we calculate the share of benchmark issues that have been bought on the primary market based on the ECB's reporting and compare this figure with the investor share reported in the deal sheets for benchmark issues (Central bank/SSA). As at the end of May 2015, a volume of EUR 15,063m had been purchased on the primary market. This is set against a cumulative volume of EUR 13,020m that has been allocated to the deal sheet of the "Central banks and SSA" investor. Bearing in mind that this data is not precise, we are assigning the entire volume to Eurosystem central banks. In this way, we calculate that benchmark issues make up an 86.4% share of all Eurosystem primary market activity under the programme. We are using the derived share of the primary market as a basis to approximate the share of the overall purchase volume attributable to benchmark issues. This results in an approximate value for purchased benchmark issues under the CBPP3 of EUR 73,533m by the end of May 2015. Based on an outstanding benchmark volume of EUR 555bn in the iBoxx Euro Covered qualifying for the purchase programme, 13.2% of this eligible index volume had been acquired so far as at the end of May 2015. Consequently, it is to be assumed that the demand generated by the Eurosystem will have an impact on spreads and returns.

In order to determine whether the covered bond purchase programme triggered significant spread movement on the covered bond market, we have allocated covered bonds in the iBoxx Euro Covered to specific portfolios and analysed their performance. Five portfolios were created overall, with the following criteria:

> Core Eurozone: headquarters of issuer in Austria, Belgium, Finland, France, Germany or the Netherlands;

> Periphery: headquarters of issuer in Ireland, Italy, Portugal or Spain;

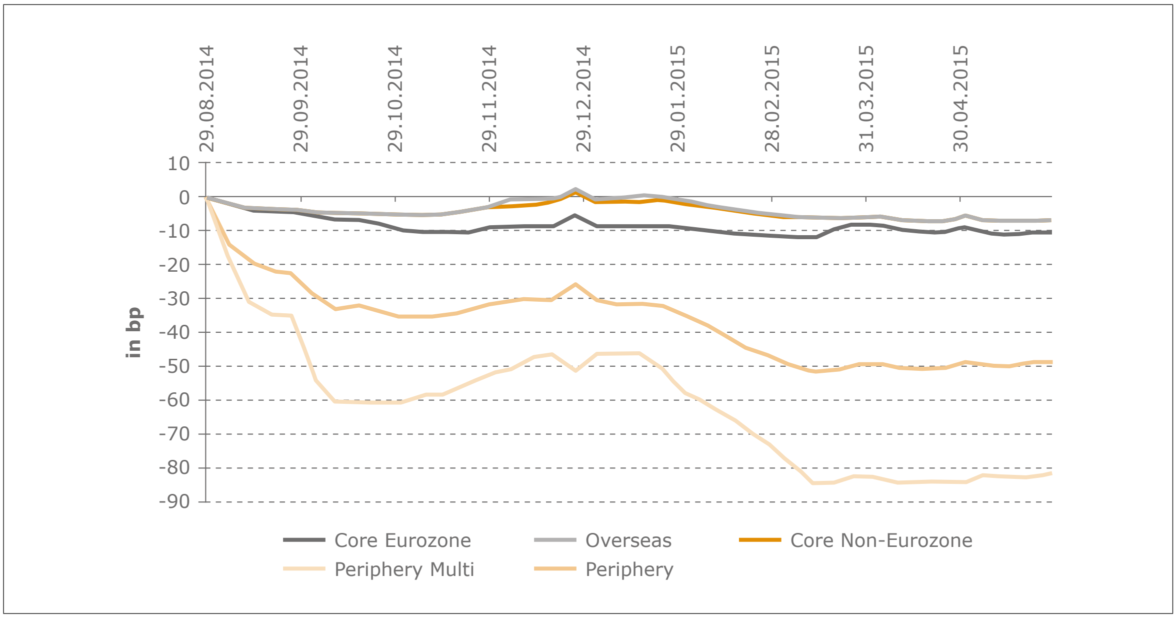
> Periphery Multi: issuer is an SPV and issues multi cédulas;

> Core Non-Eurozone: headquarters of issuer in Denmark, Norway, Sweden, Switzerland or the UK;

> Overseas: headquarters of issuer in Australia, Canada, New Zealand or the USA.

If we are correct in assuming that the programme has had an impact, then outperformance can be expected for the covered bonds which qualify for the purchase programme in the three portfolios of Core Eurozone, Periphery and Periphery Multi. To allow precise performance distribution, we have split the period being reviewed as follows: from the announcement of the purchase programme at the start of September 2014 to the announcement of its detailed modalities on 2 October 2014; from 2 October 2014 to the start of bond buying on 20 October 2014; from 20 October 2014 to the announcement of the Public Sector Purchase Programme (PSPP) on 22 January 2015; from 22 January 2015 to the start of purchases under the PSPP on 9 March 2015; and from 9 March 2015 to 31 May 2015. The period from 1 January 2014 to 31 August 2014 was used as a reference period. The respective average change per week was used to allow comparison between the periods of differing lengths.

> FIGURE 9: SPREAD DEVELOPMENT OF DIFFERENT COVERED BOND SEGMENTS



Source: NORD/LB Fixed Income Research

In the overall analysis, the Core Eurozone portfolio tightened by 11.8 bp in the period from 1 September 2014 to 31 May 2015, while even greater above-average tightening was recorded in the Periphery (48.8 bp) and Periphery Multi (81.7 bp) portfolios. In contrast, the two segments of Core Non-Eurozone and Overseas, which are not available for purchase under the CBPP3, narrowed by 7.0 bp and 6.9 bp, respectively. A comparison between the three portfolios of Core Eurozone, Core Non-Eurozone and Overseas, which each have an average rating of around AAA/Aaa, reveals outperformance for the portfolio that can be purchased under the CBPP3. In absolute terms, taking into account the two other portfolios of Periphery and Periphery Multi, an excess return is clearly evident.

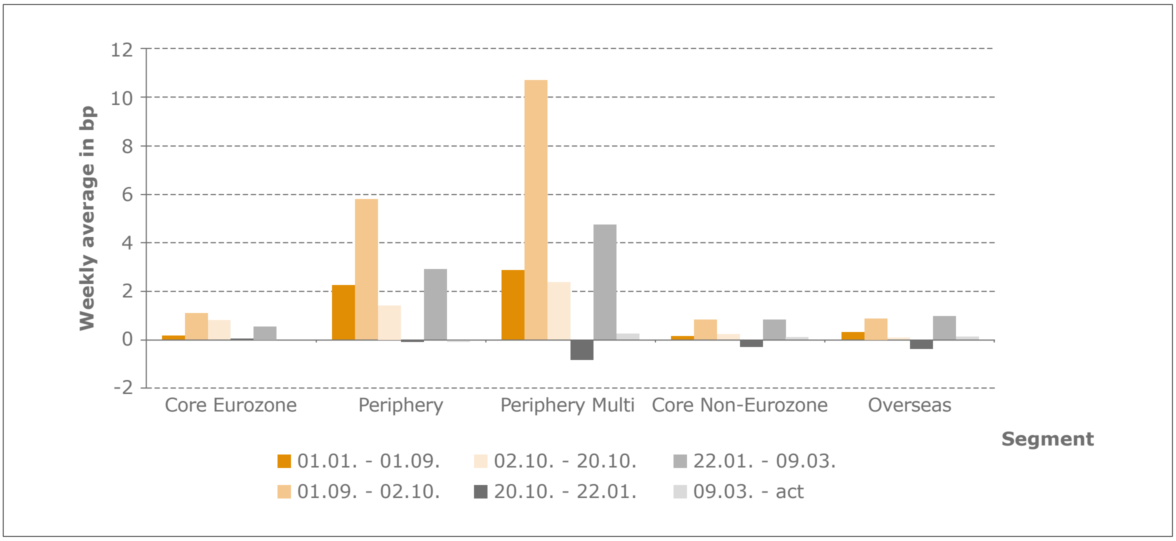
> Figure 10: Yield risk overview in covered bond segments (1 September 2014 to 31 May 2015)

	Yield	Risk	Sharpe ratio (rf = 0.10%)
Core Eurozone	1.9%	0.8%	2.3
Core Non-Eurozone	1.4%	0.5%	2.5
Overseas	1.7%	0.7%	2.6
Periphery	3.6%	1.2%	3.0
Periphery Multi	7.2%	2.4%	3.0

Source: NORD/LB Fixed Income Research

However, the results are less clear-cut for risk-adjusted performance. While the Core Non-Eurozone and Overseas segments had the lowest risk from 1 September 2014 to 31 May 2015, with standard deviations of 0.5 and 0.7, respectively, risk in the remaining three portfolios was higher. The Sharpe ratio for the Core Eurozone portfolio therefore has a value of 2.3, which is lower than the Core Non-Eurozone (2.5) and Overseas (2.6) portfolios. In contrast, the values are higher for both the Periphery (3.0) and Periphery Multi (3.0) portfolios and consequently the risk-adjusted performance is also better.

> Figure 11: Weekly change in spreads across different covered bonds segments



Source: NORD/LB Fixed Income Research

In order to determine the effect of the purchase programme on spread performance, we analysed performance in the defined periods and adjusted these on a weekly basis to ascertain which phases had the greatest impact on performance. From the above overview, it can be deduced that the best weekly performance across all portfolios occurred in the period after the programme was announced, from 1 September to 2 October 2014. Further notable gains were recorded after final details of the programme were published to the start of buying (2 October to 20 October 2014), with portfolios that qualified for the programme achieving significantly higher week-on-week changes than the Core Non-Eurozone and Overseas portfolios. Improvements were also seen after the announcement of the PSPP, with the change in the Periphery and Periphery Multi portfolios in fact greater than after the CBPP3 details were published. In contrast, no or only very low week-on-week growth was recorded in the period after Eurosystem central banks started to make purchases under the CBPP3 up to the announcement of the PSPP (20 October 2014 to 22 January 2015) as well as after the start of PSPP buying (9 March to 31 May 2015). From this, we conclude that the programmes are impacting spreads, but that this is linked to the announcements and has (so far) not been the effect of the purchases themselves.

To determine whether the CBPP3 led to outperformance of covered bonds in comparison with other asset classes, we calculated the return, risk (standard deviation) and Sharpe ratio of various fixed income indices that comprise euro-denominated bonds for the period from 1 September 2014 to 31 May 2015.

> Figure 12: Yield risk overview: iBoxx indices (1 September 2014 to 31 May 2015)

Index	Yield	Risk	Sharpe ratio (rf = 0.10%)
iBoxx € AGENCIES	1.70%	0.93%	1.82
iBoxx € BANKS SENIOR	1.57%	0.72%	2.18
iBoxx € BANKS SUBORDINATED	2.76%	1.28%	2.15
iBoxx € CORPORATES	2.00%	1.10%	1.80
iBoxx € COVERED	2.52%	0.97%	2.59
iBoxx € EUROZONE SOVEREIGNS	4.11%	2.67%	1.54
iBoxx € PUBLIC BANKS	1.56%	0.74%	2.09
iBoxx € REGIONS	2.36%	1.31%	1.79
iBoxx € SUPRAS	3.03%	2.06%	1.47

Source: Markit, NORD/LB Fixed Income Research

In the period under analysis, eurozone sovereigns achieved the highest return of 4.11%, ahead of supras (3.03%) and banks subordinated (2.76%). The lowest standard deviation, and therefore the lowest risk, was recorded for banks senior (0.72%), public banks (0.74%) and agencies (0.93%). Of the nine analysed indices, covered bonds rank fourth in terms of both return (2.52%) and risk (0.97%). As a result, covered bonds have achieved the highest value in the risk-adjusted performance analysis of 2.59, based on the Sharpe ratio. While no excess return has been identified for covered bonds in the overall analysis, it has in the risk-adjusted assessment. In our view, the higher returns for eurozone sovereigns and supras on the whole are due to the PSPP, which seemingly had a greater impact than the CBPP3.

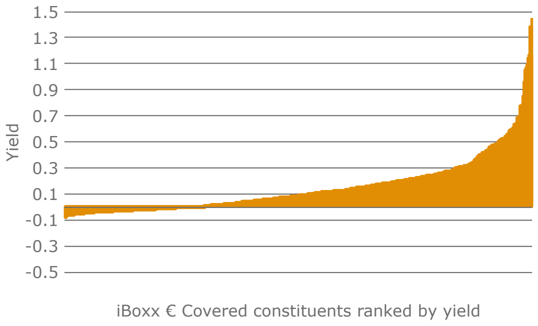
From the above analysis we conclude that the CBPP3 has had a noticeable impact on the performance of covered bonds. This is reflected in the risk-adjusted return performance since the programme was announced at the start of September 2014, while the return attribution shows that the impact is linked to the announcement, with the actual purchases by Eurosystem central banks having less of an effect. Investors are therefore acting ahead of the curve, or rather, ahead of the central banks.

TIGHTER SPREADS AND NEGATIVE YIELDS

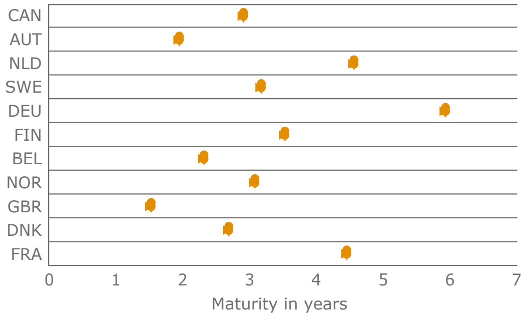
The discussed significant spread impact from the CBPP3 on covered bonds in combination with an overall low yield environment resulted in a large portion of covered bonds being (temporarily) driven to negative yield levels (as shown in Figure 13). The low yield environment reached its peak in April 2015 with 10Y Bunds yielding at

0.05%. As of 17 April 2015, out of 654 covered bonds in the iBoxx, 190 had a yield of zero or below. 146 had a positive yield, but below 0.10%, and only 10 had a positive yield of more than 1.0% (see Figure 13). This also meant, that even when going for longer maturities, the yield of covered bonds in a number of countries still remained negative, e.g. German covered bonds with a maturity of up to nearly six years had yields in negative territory (see Figure 14).

> Figure 13: Yields of covered bonds in April 2015



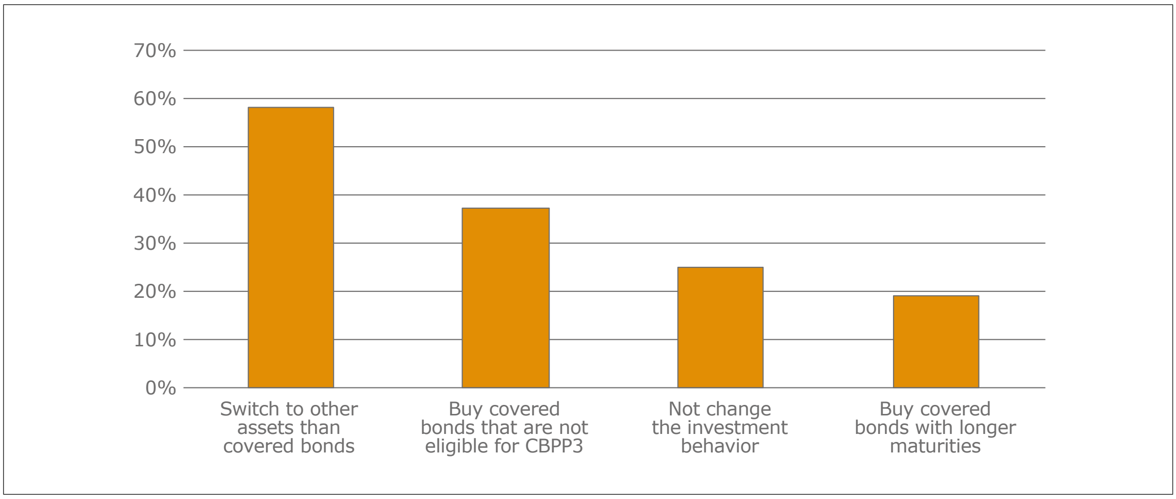
> Figure 14: Time to maturity at which yields turned positive



Source: UniCredit Research, Markit

In addition, the already low liquidity in secondary markets dried up further due to the CBPP3. As a consequence of low covered bond yields and low liquidity, some covered bond investors decided to abandon covered bonds and to switch to other asset classes. This development is also reflected in an investor survey done by Fitch and published in early 2015. Fitch's Covered Bond Investor Survey Year-End 2014 is based on the response of 52 investors, of which 12% manage more than EUR 20bn of covered bonds, 20% between EUR 5bn and EUR 20bn and 68% less than EUR 5bn. The investors concentrations were 60% in the eurozone, 88% in the European Economic Area and the remainder in Asia and the Americas. Investors were asked to choose from four different options, with multiple answers possible. The four options were 1. Switch to other assets than covered bonds; 2. Buy covered bonds that are not eligible for CBPP3; 3. Not change the investment behaviour; and 4. Buy covered bonds with longer maturities. According to the survey, 58% of the participating investors said they expect to switch to other asset classes than covered bonds as at least one of their reactions to factors as the TLTRO, the CBPP3 and quantitative easing (QE). Half of these respondents listed a switch to other assets than covered bonds as their only choice of the four options. 37% of investors selected the option of buying covered bonds that are not eligible for CBPP3. 25% of the investors did not plan to change their investment behaviour and some 19% stated to buy covered bonds with longer maturities.

> Figure 15: Investment expectations in the context of TLTRO, CBPP3 and QE



Source: Fitch Ratings, UniCredit Research

CONCLUDING REMARKS

The ECB's third covered bond purchase initiative has had important ramifications for the covered bond market, both in primary and secondary markets. Not only the targeted eurozone covered bond markets managed to reap the fruits from this, non-eurozone markets have also been supported by the positive spill-over effects of reallocations away from more expensive eurozone alternatives. Whilst the actual start of the CBPP3 in October 2014 offered stronger support to primary market activity than its announcement in September 2014, we come to a different conclusion for the secondary performance consequences. Covered bonds experienced their strongest risk-adjusted return performance shortly after the announcement of CBPP3, particularly in the peripheral eurozone markets. The significant spread impact from the CBPP3 on covered bond spreads in combination with an overall low yield environment temporarily drove a large portion of covered bonds into negative yield territory, prompting an increasing number of investors to rethink their allocations into covered bonds in favour of other bond asset classes.

1.3 CAPITAL MARKETS UNION AND THE POTENTIAL ROLE OF THE ECBC AND DUAL RECOURSE INSTRUMENTS

By Boudewijn Dierick, BNP Paribas, Moderator of the ECBC Task Force on Long-Term Financing & Chairman of the ECBC Rating Agency Approaches Working Group and
Heiko Langer, BNP Paribas

CAPITAL MARKETS UNION: WHAT IS THE PURPOSE THE EC IS TARGETING?

The aim of the Green Paper on Building a Capital Markets Union from Commissioner Hill is to gather ideas and market intelligence in order to develop better regulation by means of market initiatives that can support growth and lending to the real economy, in its role as market catalyst.

ECBC ROLE

The ECBC decided to assist and support the development of any market initiative going forward that has the potential to play a crucial role in financing growth and the real economy.

The ECBC established a Task Force on Long-Term Financing, the purpose of which was to investigate the possibility and viability of the creation of new capital instruments that make use of some key features that have made covered bonds one of the safest and most successful financial tools in use in Europe, and which played a central role in the crisis management toolkit of banks during the financial crisis by providing a safe and reliable source of funding. This article reflects the main findings of the ECBC Task Force which formed the basis of the ECBC letter to the European Commission in response to the Green Paper on Building a Capital Markets Union.

The ECBC response to the Green Paper aims at providing clear building blocks for a market initiative on a pan-European dual recourse long-term funding instrument, which would allow for the financing of asset classes beyond the traditional covered bond collateral types of mortgages and public sector assets such as small and medium-sized enterprise (SME) or infrastructure assets.

The ECBC's proposal represents a market initiative creating a new pan-European funding instrument. This initiative would require a limited legislative intervention at national level and would respond to several of the priorities for early action foreseen in the Green Paper, in particular: (i) widening the investor base for SMEs, and (ii) building sustainable high-quality securitisation.

This initiative, designed outside of the traditional covered bond space combines existing techniques and market best practices for the establishment of a funding solution for lenders that is also accessible in a stress scenario.

Traditional covered bonds have ensured financial stability and access to capital markets during the crisis thanks to very precise macro-prudential characteristics. It is important to clearly distinguish any funding solutions for SME and infrastructure loans using similar dual recourse techniques from the traditional covered bond space.

One of the key success factors is the common adoption of the same set of micro foundations and technology, in particular in terms of eligibility criteria, definitions, risk parameters, data disclosure and IT solutions across European countries. If correctly implemented, supported by a minimum level of regulatory recognition as a very high-quality product under a clear legislative and supervisory framework, it could facilitate issuers and investors in terms of due diligence, risk analysis, pricing and funding diversification.

DESIGNING DUAL RECOURSE INSTRUMENTS FOR THE LONG-TERM FINANCING OF THE REAL ECONOMY

With the spirit of the Capital Markets Union in mind, the ECBC Task Force on Long-Term Financing tried to design new bank funding tools aiming at improving banks' ability to lend to the real economy, while at the same time stimulate the growth of SMEs by promoting the use of SME loans as collateral for new European Secured Notes (ESN). The outcome of the discussion was the proposal of two possible ESN structures, each with slightly different characteristics, aimed at providing different benefits to the lender as well as to the borrower. The first type of ESN would be closer in design to covered bonds in the sense that the collateral would stay on the balance sheet and the investor would have dual recourse to both the pool and the issuer. The second type of ESN would resemble more closely what is referred to as "high-quality securitisation". This could provide risk sharing (and capital relief) to the issuing institution (as the collateral would be transferred onto an SPV[1]), but also still retain a form of dual recourse. In both cases, the collateral could be SME loans.

These two major lines of development (on-balance sheet and risk sharing) could be implemented through a bottom-up approach, which would aim at amending the current legislative frameworks by adopting common definitions, risk parameters and market best practices (even if this may be implemented *de facto* through different legal options/solutions at national level). This combination of common European guidelines, flexibility and adaptability in the implementation at national level should ensure a smooth adoption of this structure in what remains a heterogeneous market, as well as supervisory and legislative landscape.

ON-BALANCE SHEET EUROPEAN SECURED NOTES (ESN) USING COVERED BOND FUNDING TECHNIQUES

The "on-balance sheet ESN" would be similar in structure to a covered bond. As such, it could have the obvious advantage of benefiting from regulatory recognition, thus providing the issuer with an additional tool to fulfil liquidity requirements such as the Liquidity Coverage Requirement (LCR). In fact, the transformation of SME loans into an ESN would improve the regulatory and prudential treatment of such assets, by making the bond UCITS[2] compliant, and therefore exempt from bail-in, and eligible for a number of prudential and regulatory requirements, such as under Solvency II. In this context, two elements are necessary in order for the ESN to successfully play this role: (i) a robust specific legal framework around the creation of such an instrument; and (ii) a sufficiently high level of transparency regarding the asset pool.

The existence of a legal and supervisory framework is one of the major strengths of covered bonds. This should also be developed for on-balance sheet ESNs, whereby the asset pool would have to fulfil specific criteria. These include, but are not limited to: a harmonised definition of SME loans allowed as eligible collateral; clear rules on the segregation of the pool for the safety of the investor; appropriate levels of over-collateralisation (OC); and clear *pari-passu* priority claims of the investor to the issuer's assets in the case of default and insufficiency of the pool to cover the value of the bond.

In addition, the eligibility criteria for SME loans need to be developed. A good starting point for this may be the European Central Bank's (ECB) collateral framework, which allows the use of credit claims as collateral for repo operations[3]. This alignment would ensure greater marketability and liquidity of the ESN. The second requirement, i.e. transparency, is very much linked to the first point, as it is a necessary condition for the accurate assessment of the true underlying risk of the SME assets used in the pool. High levels of transparency would facilitate due diligence and allow investors to effectively understand the underlying risk. However, more importantly, it would allow issuers to effectively manage their portfolio. Therefore, it is of paramount importance to develop an effective transparency framework, which would entail a close cooperation with the SMEs whose loans are included in the pool.

RISK SHARING EUROPEAN SECURED NOTES (ESN) – USING HIGH QUALITY SECURITISATION TECHNIQUES

This ESN structure would provide benefits to both the issuer and the investor which would share some risks and be remunerated accordingly. It could offer both funding and some capital relief to the issuer, which would thereby be able to use freed-up capital for additional lending; this would also have the advantage of lowering capital requirements. For the investor, this ESN structure, while maintaining the alignment of interests between

[1] Special Purpose Vehicle (SPV).

[2] http://ec.europa.eu/finance/investment/ucits-directive/index_en.htm.

[3] https://www.ecb.europa.eu/pub/pdf/scpops/ecbocp148.pdf.

originator and investors, would potentially be more interesting in terms of yield, which is a central aspect in the current environment of low interest rates.

This alternative ESN structure would, in some respects, have analogies with the securitisation techniques in the sense that the assets used in the pool would be transferred to an SPV via true sale or pledged using, for example, the collateral directive to prevent the need of a true sale at closing. In this case, as for traditional securitisation, the pool could either remain static or have a replenishment period of a few years, which would represent a difference *vis-à-vis* traditional covered bonds where the pool is dynamic (which would also be a characteristic of the "on-balance sheet ESN") throughout the life of the covered bond programme. In fact, the dual recourse principle could apply, although in a different way to that for the "on-balance sheet ESN", for example via the issuer providing a guarantee for part or all of the ESNs issued.

As with traditional securitisation, this second ESN structure would be tranched and each tranche would be secured by the portfolio of SME credit claims. Two basic general principles should be satisfied: (i) the originator must comply with the retention requirements ("skin in the game") by either retaining the junior tranche of 5% or more, at least 5% of each tranche or a 5% portfolio of similar risk on its balance sheet; and (ii) public/international institutions could play a role in investing in or in guaranteeing some tranches (senior to equity) of the security in the spirit of promoting the development of the securitisation market and the financing of the real economy through SMEs.

Following this logic, one possible example of a design for this kind of instrument would be one where the originator (issuer), and/or another highly-rated financial institution, guarantees the senior tranche of the ESN. The equity tranche could be guaranteed by institutions such as the European Investment Bank Group (EIB Group, in particular the European Investment Fund); the mezzanine tranche could be guaranteed by government-owned development banks (such as KfW Development Bank in Germany, Cassa Depositi Prestiti (CDP) in Italy, Instituto de Crédito Oficial (ICO) in Spain or Caisse des Dépôts et Consignations (CDC) in France), again, to encourage public involvement and the sponsoring of securitisation as a means of financing the real economy.

This ESN structure could, through its features, aim at tackling the fragmentation of EU capital markets, and encourage a cross-border market for SME financing throughout the Union. Moreover, the legal safeguards and flexibility of using an on-balance sheet approach and/or risk sharing techniques would reduce the pro-cyclicality of the ESN instrument, thus rendering it especially useful in enhancing the resilience of long-term financing in times of crisis.

It is important to note that, as for the "on-balance sheet ESN", the "risk sharing ESN" would need to rely on robust transparency requirements, as well as a legal framework to safeguard investors and issuers. In addition, this ESN structure would also depend on the willingness of such international/public institutions to support the instrument through guarantees. Nonetheless, there is a clear intention by EU and national authorities to support the securitisation market, as well as the financing of the real economy and SMEs. Of course, it is pivotal that the risks involved are accurately identified, standardised and mitigated where necessary. This is a *conditio sine qua non* for the involvement of other parties in these transactions.

HOW WOULD SUCH INSTRUMENTS DIFFER FROM TRADITIONAL COVERED BONDS?

Despite the similarities between ESN and covered bonds, it is important to highlight the features that distinguish covered bonds from ESN. The main distinguishing feature is the different collateral used to secure ESN in comparison to the collateral of covered bonds. Covered bonds use highly standardised and low-risk assets, mainly mortgage loans and claims against public sector entities, as collateral. The high level of standardisation of cover assets is a key element that facilitates the analysis of covered bonds, limits research effort and increases comparability within the covered bond sector. Using highly standardised assets also makes it easier to define eligibility criteria for the cover assets that can be used on a relatively broad basis, i.e. in a larger number of jurisdictions.

The use of low-risk assets as collateral is one cornerstone of the high level of investor confidence that covered bonds enjoy. The concept of dynamic collateralisation based on asset substitution through the issuer is more acceptable for investors if new assets which are added to the cover pool will meet certain minimum criteria. For issuers the use of high quality collateral means more a stable credit quality of the cover pool and ultimately less frequent asset substitution. The use of other, potentially more risky asset classes for ESN makes a clear distinction between covered bonds and ESN necessary as the risk profile of the two instruments could vary significantly.

A further distinguishing factor between covered bonds and ESN, at least at an initial stage, would be the established track record that covered bonds enjoy. Together with robust national legal frameworks, the long standing track record of covered bonds has helped to make them more reliable and stable. The long track record, which is the basis for a deep and diversified investor base, helps to support market access of covered bond issuers also in time of stress. The robust market access itself in an important stabilising factor for covered bonds. Drawing a clear line between covered bonds and ESN will help to protect the track record of covered bonds against potential dilution that could occur through the introduction of instruments that bear similarities to covered bonds but may have a different risk profile.

MAIN FINDINGS OF THE ECBC TASK FORCE ON LONG-TERM FINANCING

The work of the ECBC Task Force on Long-Term Financing resulted in a comprehensive evaluation of the possibility of creating such ESNs. The Task Force was divided into four Work Streams, each focusing on different aspects:

> **Work Stream I** focused on the identification of core common macro-prudential and legal characteristics of dual recourse instruments in order to secure bondholders and other creditors of the issuing institution;

> **Work Stream II** on the mapping of current interest and developments in the implementation of other collateral in dual recourse instruments;

> **Work Stream III** on the analysis of investors' needs and perspectives, including the identification of transparency and risk assessment parameters; and

> **Work Stream IV** on the definition and analysis of a potential European toolkit for a dual recourse funding model implementable at national level, in particular analysing the issuer's perspective and identifying potential blocking factors.

Work stream I identified the following common legal and macro-prudential characteristics of dual recourse funding instruments:

> Investors have a claim on the issuer and a preferential claim on the asset pool.

> Investments are eligible for LCR and ECB repo and have preferential risk-weighting (CRR).

> Investors take comfort from a legal status and special supervision of the product.

> Transparent underwriting and reporting standards of the respective loan product.

Work Stream II made the following observations:

> European authorities encourage expansion into new collateral classes.

> Several countries developed new (law-based or structured) dual recourse funding instruments.

> Lack of supply due to a mixed set of reasons.

> Investor demand mixed; investor education needed.

> New dual recourse funding instruments lack preferential treatment of covered bonds.

> Regulatory obstacles means securitisation often better suited.

> Financing via state-guaranteed agencies often cheaper.

> Trade-off between "relying on traditional collateral" and "expanding the importance of asset class".

What are the main reasons for the relatively low supply of dual recourse funding instruments backed by other collateral?

- Lack of investor demand (regulatory treatment, lack of understanding, "wrong" assets).
- Regulatory issues (risk weighting under CRR, Solvency II, LCR, ECB repo eligibility).
- Rating agencies' concerns.
- Asset encumbrance problematic combined with cheap senior unsecured funding.
- Low overall funding needs due to lack of loan demand, (T)LTROs, deleveraging.
- Often securitisation better suited.
- Competition from agencies (KfW, Rentenbank, L-Bank, NRW.BANK, ICO etc.).

Work Stream III elaborated a survey to relevant covered bond investors. The survey discussed the conditions of the hypothetical implementation of a new dual recourse funding instrument, focusing on both its potential structure and collateral.

Although the survey points out that investors think there is undisputable room for innovation on the covered bond market, it also emphasised the investors' preference for standardisation on structuring, monitoring and reporting. Most investors tend to favour harmonisation on the market with law-based instruments rather than contractual, arguing that innovation would require more pool information and a premium. With a clear preference for granularity and homogeneity of the covered pools, investors' minds are open to face non-traditional collateral if combined with higher yield. The dual recourse principle remains very important for new products.

Work stream IV identified some key pillars for a successful new dual recourse instrument:

- Recourse to the segregated asset pool following default of the issue, ideally a banking issuer even though from a technical perspective, dual recourse bonds could be issued by a SPV issuer as well.
- Homogeneous and dynamic pool of assets with a robust internal/external monitoring process.
- High degree of transparency on structure, assets and clear allocation of roles.
- Capability to ensure some capital relief.
- Support from regulators and supervisors: Eligibility for national central banks' (NCBs) refinancing operations, LCR and NSFR, and preferential treatment for investors as well as bail-in exemption.

THE WAY FORWARD: THE ROLE OF INSTITUTIONS AND THE MARKET

Looking ahead, the success of these instruments would rely on both a robust legal framework and a high level of transparency regarding the underlying assets. The development of centralised credit registers[4] with harmonised levels of information would provide the ideal tool for the achievement of full transparency (while complying with confidentiality laws), and the subsequent increased level of security of these ESNs. All parties involved would be able to accurately assess risks and thereby differentiate their portfolios accordingly, contributing to the quality of the instruments. This links closely to the other condition, i.e. a robust legal framework, which among other things would focus on determining which assets can be used as collateral. Having transparent information regarding these SME loans is a central aspect of this issue.

[4] One example of this could be the Analytical Credit Dataset (AnaCredit) "The development of a steady state approach for an analytical credit dataset will continue in 2015 in close collaboration with the FSC. This entails drafting a new ECB regulation and guideline for the collection of granular credit data and the development of an IT tool for data collection, maintenance and dissemination.", source: http://www.ecb.europa.eu/stats/pdf/2015_ESCB_statistics_work_programme.pdf?ef1338e0f89fd91d3fd02f033aad73a6.

Moreover, the issuer, regulatory and investor community should work together to develop common eligibility criteria for assets (which could be inspired by the ECB collateral eligibility criteria for credit claims as well as EIB Group activity). Establishing a pan-European standard in terms of securities backed by SME or infrastructure loans would be a cornerstone of the strength of this product. Regulatory frameworks and existing laws should be amended to allow these new asset classes to be used as collateral within the regulatory and prudential framework. In order to drive the effort forward, contributions from the institutional side as well as the market side should include the following points:

Institutional side (ideally supported by the European Commission):

- Establish an Advisory Council acting as a discussion forum for finance ministries, central banks, potential sponsors and investors.
- Work on micro-foundations, e.g. on clear definitions on SME categories and criteria for infrastructure loans.
- Create a common legal framework for the new instruments (or amend existing laws). For example, by expanding the collateral directive and allowing it to be used for SME loans.
- Provide support for the "risk sharing ESN" by guaranteeing the non-senior tranches of the security.
- Create common SME loans registers (in co-operation with relevant market participants).

Market side:

- Create common eligibility guidelines for cover assets.
- Set up a committee on asset transparency.
- Create common credit registers (in co-operation with relevant institutions).
- Establish and develop a specific governance platform and quantitative database inspired by the design, experience and success of the Covered Bond Label.
- This potential market platform should provide full comparability and transparency using the same format and definitions at European level in three areas (cover assets, liabilities and legislative framework) with the ultimate aim of facilitating market participants' due diligence and reducing reliance on rating agencies.

CONCLUSION

The success of covered bonds and in particular their resilience during the financial crisis have made them an obvious model that can be used as example for the creation of a new pan-European funding instrument. The creation of such instruments is an important step towards establishing deeper and more integrated capital markets, which is a key objective of the Capital Markets Union initiative. Drawing from the experience of a long standing but also dynamically expanding covered bond market will help to save time and increase efficiency when creating a new funding instrument. At the same time it is important to draw a clear line of distinction between covered bonds and ESN. While there is a multitude of structures and structural features available for the establishment of a new funding instrument, the inclusion of certain key features should be considered in order to achieve a high level of market acceptance. Contributions from the institutional side as well as the market side could help to further increase the chances of a successful launch of ESN.

1.4 COVERED BOND SUPPLY TAKES A HIT AS BANKS BUFFER UP

By Alexandra Schadow, LBBW and Maureen Schuller, ING Bank

BANK RECOVERY AND RESOLUTION DIRECTIVE (BRRD) IS BEING TRANSPOSED INTO NATIONAL LAW

The BRRD is embedded in the full set of rules of the European Banking Union, which also includes the Single Supervisory Mechanism (SSM) and Single Resolution Mechanism (SRM) Regulations. The SSM and SRM, however, apply initially only to the member states of the European Monetary Union (EMU). The BRRD is currently being transposed into national law in the European Economic Area (EEA). In a bank recovery and resolution situation, four tools are generally available: sale of business, bridge bank, asset separation, and bail-in. Our focus is above all on the bail-in tool, which can only be implemented if sufficient bail-in-able capacity is available.

THE BASIC IDEA OF A BAIL-IN

The bail-in tool is to be used by the resolution authority to recapitalise an institution. The objective is either to restore a resolution institution to such an extent that it has sufficient capital to meet the regulatory requirements or to provide the claims and liabilities that are to be transferred with sufficient capital. The resolution authority can achieve this by using existing equity and writing down or converting the eligible liabilities. The principle that no creditor may be worse off than in a regular insolvency applies.

However, two significant procedural points have to be observed in a bail-in. First of all, an exact order must be adhered to. This starts with the shareholders followed by the various other asset classes in a given order. Second, certain liabilities are explicitly excluded from a bail-in by the provisions of the BRRD. One important exclusion is covered bonds that conform to Article 52(4) of the Undertakings for Collective Investment in Transferable Securities (UCITS) Directive 2009/65/EC. The Directive merely restricts the exclusion by allowing covered bonds to be bailed-in if the liabilities from the covered bond exceed the relevant collateral in the cover pool and the resolution authority considers it appropriate to bail-in that "uncovered" portion. However, this would amount to undercollateralisation. It should be pointed out that covered bond legislation, despite national differences, always provides for sufficient cover. The issuer is required to eliminate any undercollateralisation that arises without delay.

The main objective of a bail-in is to ensure that shareholders and creditors of the defaulting institution bear an appropriate part of the costs arising from the failure. This requires that all institutions have sufficient "bail-in-able" capacity. To this end, the BRRD lays down a separate requirement under Article 45 known as the minimum requirement for own funds and eligible liabilities (MREL). This concludes our description of the European dimension.

We now turn to the global dimension. The Financial Stability Board (FSB) identified the same issue for global systemically important banks (G-SIBs) and presented a consultation paper with its initial views in November 2014. In this case, the requirement is referred to as the total loss absorbing capacity (TLAC). The MREL is due to be introduced in 2016, while TLAC will follow from 2019. However, there are a number of differences in the details, which we consider below.

MINIMUM REQUIREMENT FOR OWN FUNDS AND ELIGIBLE LIABILITIES (MREL)

Through the MREL ratio, the BRRD requires a bank to have sufficient own funds and eligible liabilities. Own funds consist of core capital and supplementary capital. Eligible liabilities mean liabilities and capital instruments that are not explicitly excluded from a bail-in under the BRRD. The latter category includes covered bonds. In general, therefore, only bail-in-able capital instruments can count towards eligible liabilities. In addition, MREL-eligible instruments must meet further requirements. For example, they must have a residual maturity of at least one year, have fully paid up capital and must not be liabilities from derivatives. The MREL discussion therefore focuses on CET1, additional Tier 1, Tier 2 and senior debt. Both Pillar 1 and Pillar 2 capital components are allowed, which permits banks to include various capital buffers. Although the calculation is prescribed as set out below, no general minimum ratio has been set so far.

$$\frac{\textit{own funds + eligible liabilities}}{\textit{own funds + total liabilities}} = \text{MREL}$$

The MREL is determined on a case-by-case basis for each institution according to six criteria (Article 45 (6) (a)-(f) BRRD). The EBA has been tasked with submitting a technical standard to the European Commission by 3 July 2015 that considers these criteria in further detail. The final draft (EBA/RTS/2015/05) provides the details and the proposal for a delegated regulation which was submitted to the European Commission:

> **Resolvability:** The institution must be resolvable according to the provisions of the BRRD and with the assistance of the BRRD tools. The focus is on the resolution objectives and requirements according to which the resolution authority assesses and decides whether a regular insolvency (liquidation) or an orderly resolution is to take place.

> **Capital adequacy:** Sufficient funds and liabilities should be available to absorb losses and enable a bank to be recapitalised and to meet the regulatory capital requirement. The regulatory capital rules (including buffer) should be applied as the starting point for the necessary provision of funds and liabilities. On that basis, case-by-case requirements can be defined for single institutions. These must, however, be justified.

> **Exclusion of eligible liabilities:** In general, it is possible to exclude eligible liabilities. As a consequence, the remaining eligible liabilities will have to meet the MREL and will have to be raised accordingly. Covered bonds are generally not eligible and are therefore excluded from the outset.

> **Deposit guarantee scheme (DGS):** The contribution that an existing DGS can make in a resolution should be taken into consideration. This is based on the lower of (1) the amount by which the covered deposits would have been written down in an insolvency without the protection of the DGS or (2) 50% of the target level of the deposit guarantee scheme (unless national levels are higher).

> **Size, business model, funding model and risk profile:** Besides the size of a business, different business models, funding structures and risk profiles will play a major role when it comes to determining the MREL. It is recommended to examine whether the regulatory requirements for the respective institution are adequate.

> **Systemic risk:** A further key factor is the systemic relevance of the individual institution and a resolution's potential negative impact on financial stability (contagion affecting other institutions).

MREL provides for mortgage credit institutions to be treated differently. This is one exception in the BRRD concerning mortgage credit institutions financed by covered bonds. If they are not allowed to receive deposits, the resolution authority can exclude them from the MREL requirement. This, in turn, is only possible in case of a realizable winding-up according to a national insolvency procedure or other types of measures in accordance with the resolution tools in the BRRD and within the scope of the resolution objectives.

In addition, the EBA must submit a report to the European Commission by 31 October 2016 that examines the various business models among other things. The emphasis is on identifying the business models and on the adequate minimum requirement with regard to the MREL. The details of the report could be very interesting for all covered bond issuers with their respective business models.

On the timeline, the EBA grants banks a transitional period in which to meet the MREL, although this should not exceed 48 months.

TOTAL LOSS-ABSORBING CAPACITY (TLAC)

In a consultation paper of November 2014, the FSB also drew up a requirement for global systemically important banks (G-SIBs) to hold a minimum amount of loss-absorbing capacity (TLAC). This is mainly designed to ensure that, in the case of a resolution, a bank has sufficient resources to absorb losses and that the "too big to fail" problem (TBTF) is ended. A quantitative impact study (QIS) on this issue is due to be presented by the summer of 2015, while it is planned to finalise the proposals at the next G-20 summit in November 2015. An introduction is scheduled for 2019 at the earliest. In contrast to the MREL, specific ratios will be set for the TLAC. At least two conditions will have to be met:

$$\frac{\textit{Total capital + TLAC eligible liabilities}}{\textit{Risk weighted assets (RWA)}} = 16\% - 20\%$$

and

$$\frac{\textit{Tier 1 capital}}{\textit{Exposure measure}} = 3\%\ \textit{(Basel III Leverage Ratio) x 2} = 6\%$$

The minimum Pillar 1 TLAC requirement is restricted to the Basel III minimum capital requirements. Capital buffers are explicitly excluded. In addition, TLAC-eligible liabilities will also be recognised and must account for at least 33% of the TLAC. The question now arises as to what liabilities are eligible for the TLAC. In this connection, the FSB explicitly focuses on instruments that can be written down or converted. Moreover, further criteria such as a remaining maturity of at least one year must be met and no liabilities arising from derivatives are allowed. In addition, certain liabilities are excluded; among these are liabilities preferred to normal senior unsecured creditors (see also Figure 1). There is therefore a significant difference to the MREL in the case of senior unsecured bonds. As currently structured, they are not TLAC-eligible. In this connection, the FSB demands that an explicit subordination is established. There are three different ways in which this can be achieved. First, it can be done structurally: liabilities eligible for TLAC purposes must not rank pari passu with, or senior to, excluded liabilities. This can best be achieved if bonds are issued at a holding company level, which is at the very top of the resolution entity structurally and/or organisationally. Second, it can be done on a contractual basis: the possibility under discussion is to subordinate the TLAC-eligible bonds on a contractual basis. They would then assume a position between normal senior unsecured bonds and T2 bonds. A third option would be a statutory subordination in the creditor hierarchy with junior status to all excluded liabilities.

> Figure 1: Comparison between MREL and TLAC

Key features	MREL	TLAC
Scope	All banks within the scope of BRRD	G-SIBs only
Timeline	Effective from 1 January 2016 Transition phase-in of four years	Effective from 1 January 2019
Calculation	Own funds + eligible liabilities Own funds + total liabilities (total assets)	Total capital Risk weighted assets (RWA) *and* Tier 1 capital Exposure measure
Determination	Case-by-case for each institution including Pillar 1 and Pillar 2	Common Pillar 1 requirement set within the range of 16-20% of RWAs and twice the Basel III Tier 1 leverage ratio Pillar 2 requirement case-by-case possible
Capital buffers	Included	Excluded
Subordination requirement	No	Yes
Priority	- not a precondition in the BRRD	- contractually subordinated - junior in the statutory creditor hierarchy - structurally subordinated, e.g. holding company
Eligible instruments	Own funds=Tier 1 capital + Tier 2 capital Eligible liabilities: - liabilities and capital instruments that do not qualify as CET 1, AT 1 or T 2 instruments and that are not excluded from the scope of the bail-in tool by virtue of Article 44(2) - issued and fully paid up - not owed to, secured or guaranteed by the institution itself - not arising from a derivative - not arising from a preferred deposit - remaining maturity of at least one year	Total capital=Tier 1 capital + Tier 2 capital TLAC eligible liabilities: - liabilities that can be effectively written down or converted into equity without disrupting the provision of critical functions or giving rise to material risk of successful legal challenge or compensation claims - issued and maintained by resolution entities - not liabilities that are funded directly by the issuer or a related party of the issuer - not liabilities arising from derivatives - not insured deposits - minimum remaining maturity of at least one year - not subject to set off or netting rights - not liabilities which are preferred to normal senior unsecured creditors under the relevant insolvency law

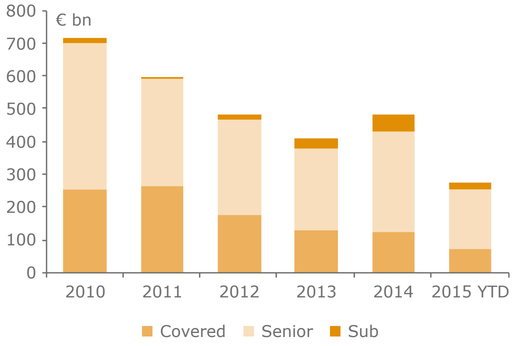
Sources: ECB, FSB, LBBW Research

The MREL and the TLAC want the same thing: bail-in-able instruments that are available in a resolution. Despite all the current differences, we therefore expect that the concepts will ultimately converge. Nevertheless, in our view the requirements set out above represent a massive intervention in the liability structures of the banks. To achieve the required minimum volumes of bail-in-able instruments, we are likely to see, in the case of contractual subordination, lasting shifts on the liability side towards "new" senior unsecured bonds. However, in the structural and statutory approaches there is also likely to be a strategic shift towards TLAC-eligible instruments. Among the funding instruments, the "victims" could include not only deposits, but also covered bonds. The latter are also in the spotlight in connection with the asset encumbrance debate. The consequence would be that the banks' already strained profitability would come under further pressure as funding through unsecured bonds becomes more expensive. Moreover, we believe that a greater dependency on wholesale funding raises the risk that banks will find it more difficult to access the capital market in difficult periods. Covered bonds would then be the right choice again. In our opinion, a balanced and sustainable funding mix should be defined as the overriding goal. For investors, analysing the liability structures of the single issuers in the context of EU law in conjunction with national rules will become a key success factor. Below, we take a closer look at these details.

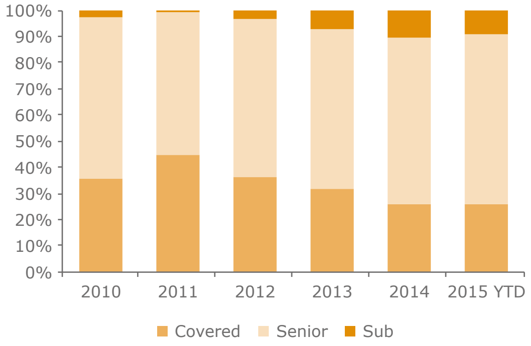
ENHANCING G-SIB SOLVENCY SETS THE STAGE FOR LOWER COVERED BOND SUPPLY

Tougher capital requirements and the adoption of resolution measures, such as bail-in tools, have prompted banks to rethink funding strategies in the past several years. The declining importance of the covered bond as a funding instrument has been just one of the consequential side effects of this global policy strengthening. Covered bond supply by European issuers fell from EUR 267 bn in 2011 to EUR 127 bn in 2014 according to Dealogic numbers. While balance sheet rightsizing has been the number one dampener to debt issuance by banks, covered bonds also appear to have lost part of their charm within the broader funding palette for banks. Nowadays, European banks barely attract a quarter of their annual funding needs via covered bonds down from 45% in 2011.

> Figure 2: Covered versus non covered supply (€bn)



> Figure 3: Covered versus non covered supply (% share)

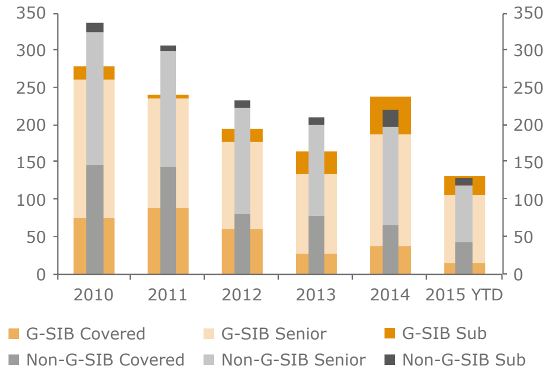


Source: Dealogic, ING

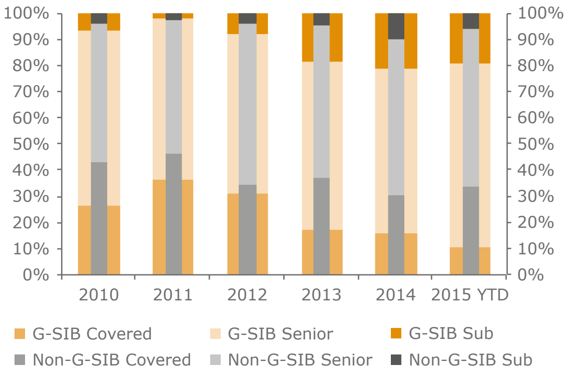
Although European banks are still processing the implications of the bail-in buffer requirements imposed by the BRRD, the region's G-SIBs see further funding challenges as a consequence of the FSB's TLAC proposals. This adds yet another important dimension the sector's liability management emphasis, considering that it is typically G-SIBs that have catalysed the current erosion in covered bond supply.

To illustrate this point, Figure 4 breaks down the bank supply statistics for European countries that are domiciles for G-SIBs, comparing the funding attracted by these banks versus the funding attracted by non-G-SIBs in these jurisdictions. Last year the total amount of debt issued by G-SIBs outpaced the funding attracted by domestic peers for the first time in five years. However, this was not the case for covered bonds. As a matter of fact, the share of covered bonds in the total print by European G-SIBs fell from 37% in 2011 to 11% YTD (Figure 5). Non-G-SIBs still attract 34% of their funding via covered bonds compared to 47% in 2011. Therefore, the tougher capital/buffer requirements imposed on G-SIBs have particularly caused these banks to shift towards bank capital and senior issuance at the expense of covered bond supply.

> Figure 4: G-SIB versus non-G-SIB funding (€bn)



> Figure 5: G-SIB versus non-G-SIB funding (% share)



Source: Dealogic, ING

THE MREL AND TLAC YARDSTICKS: COMPARING BAIL-IN BUFFERS

This prompts the question whether this trend will be amplified by the FSB's TLAC proposals or not? As described in greater detail in the first section of this article, the TLAC proposals may affect G-SIB funding behaviour quite differently as compared to the BRRD's MREL requirements.

Formula numerator differences

- By adding capital buffer requirements, such as the capital conservation buffer, countercyclical buffer and/or SIFI surcharge or systemic risk buffers to the basic Pillar 1 minimum, the TLAC buffer requirements exceed the proposed 16% to 20% level. Taking another perspective, adjusted for capital buffer requirements, the available eligible capital becomes significantly lower when measured against the minimum 16% to 20% target. While capital buffers are excluded in the case of TLAC, they can be included for MREL purposes.
- Existing senior unsecured debt buffers that are MREL-eligible, may turn out to be TLAC-ineligible, unless more jurisdictions follow the example set by the German legislators in March 2015. The German proposals explicitly identify senior unsecured bonds as ranking ahead of other unsecured liabilities in a bail-in scenario. As discussed, TLAC-eligible debt instruments must be issued by a resolution entity that does not have the excluded liabilities on balance sheet (holding company), unless these instruments are contractually subordinated to, or junior in the statutory creditor hierarchy to, excluded liabilities of the entity (such as excluded deposits).

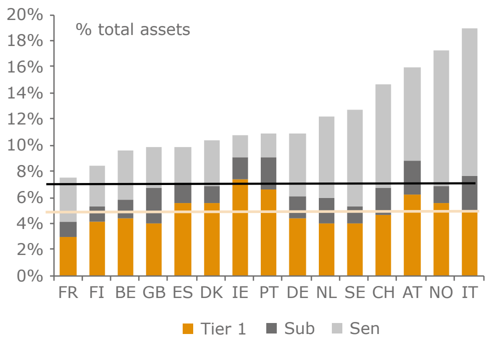
Formula denominator differences

- The BRRD bail-in buffer and MREL requirements are stated as a percentage of the total liabilities and own funds of the institution. The TLAC eligible buffers are expressed as a percentage of the entity's risk-weighted-assets. Yet the two do meet each other halfway. The BRRD provides for a derogation to the institution's own minimum loss absorption requirement of 8% before a resolution financing arrangement can contribute, if the bank itself provided for loss absorption and recapitalisation in excess of 20% of the bank's risk- weighted assets. The TLAC in turn, provides for a minimum Pillar 1 requirement of two times the 3% leverage ratio. The latter ratio is expressed as a percentage of the exposure measure, which includes, among others, all on-balance sheet assets.

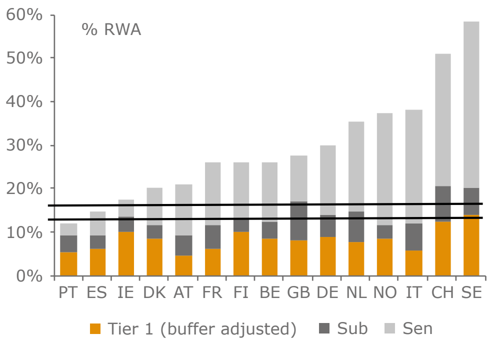
As an approximation for the potential funding implications of these two approaches, Figure 6 and Figure 7 plot the Tier 1, subordinated and senior unsecured buffers with a maturity of one year or more for a selection of European bank entities (14 G-SIBs and 20 non-G-SIBs, predominantly D-SIBs). Figure 6 depicts the average bail-in buffers per jurisdiction as a percentage of respective total assets. The 6% line in the chart is a rough guidance to the minimum leverage ratio related buffer target under the TLAC proposals. The 8% line reflects the minimum 8% BRRD buffer requirement before a resolution financing arrangement can step in under a bail-in scenario, which we use here as a proxy for the MREL. Figure 6 suggests that the Irish, Portuguese and Austrian banks in our sample have sufficient capital and subordinated debt available to meet the 8% requirement. All other banking sectors in our sample have parts of their senior unsecured debt exposed to bail-in risks to meet the 8% floor.

Figure 7, on the other hand, plots these buffers as a percentage of the issuing entities' risk- weighted assets (as per the TLAC proposals for G-SIBs). We included the available senior buffers in this graphic for illustrative purposes, although there is still significant discussion as to the eligibility scope of senior unsecured instruments for the TLAC requirements. As the banks in our sample are predominantly G-SIBs or D-SIBs, we adjusted the available capital buffers for the 2.5% capital conservation buffer and a 3% systemic risk buffer. In the case of Norwegian and Swedish banks we also take the 1% countercyclical buffer requirement into consideration. The resulting buffers are plotted against the 16%-20% proposed TLAC buffer yardstick. If the TLAC requirement also were to become standard for non-GSIBs, the Portuguese, Spanish and Irish banks in our sample would have further work to do to meet this target while their capital and subordinated buffers seem to be in good shape to meet the BRRD 8% level.

> Figure 6: Bail-in buffers (% total assets)



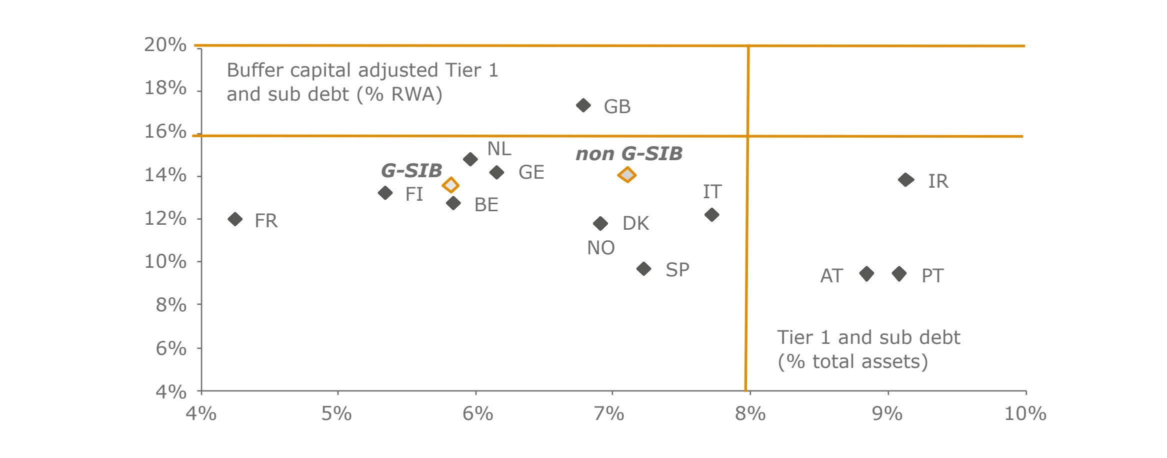
> Figure 7: Bail-in buffers (% RWA)



Source: SNL, ING

To summarise the bail-in buffer implications per jurisdiction arising from the MREL and the TLAC standards, Figure 8 aggregates both analyses. For the purpose of this graphic, we only take the available Tier 1 and subordinated buffers into consideration. The existing available senior unsecured buffers are excluded, as they may well be when strictly applying the FSB's drafted TLAC definition. Figure 8 confirms the dissimilar outcome of the two approaches. Jurisdictions that have made good (capital buffer) progress in terms of meeting the BRRD requirements, would be penalised by the TLAC proposals due to their relatively higher risk-weighted assets. Banking sectors that rank ahead of other jurisdictions on the TLAC yardstick, perform poorer on the MREL definition.

> FIGURE 8: MREL AND TLAC SUGGEST DIFFERENT OUTCOMES

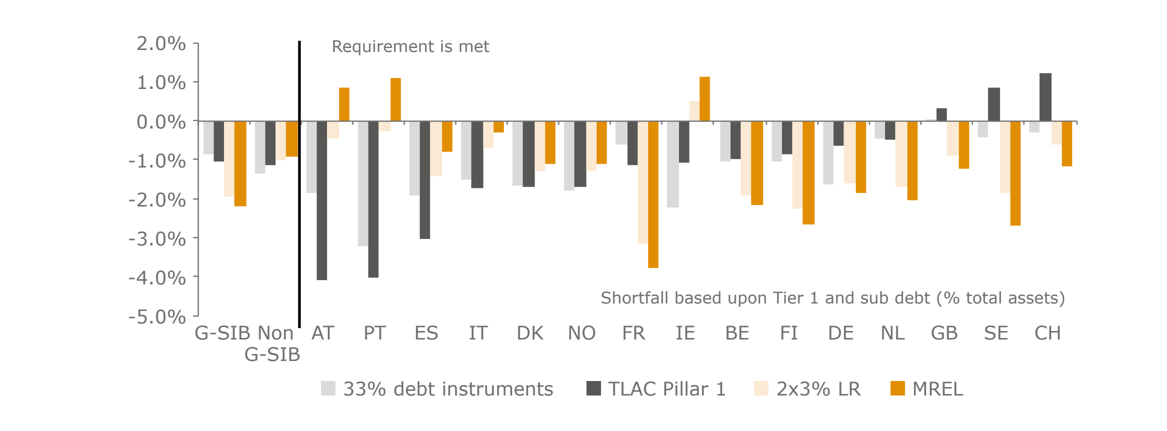


Source: SNL, ING

WHAT SHORTFALLS ARE LIKELY TO DEFINE FUNDING BEHAVIOUR?

Figure 9 converts the bail-in buffer shortfalls (excluding senior buffers) under the different loss absorbing requirement definitions into a percentage of the institutions' total assets. Figure 9 also gives an indication of the shortfall related to the TLAC minimum 33% debt instrument requirement, if only the available Tier 1 and Tier 2 capital instruments in the form of debt are considered.

> FIGURE 9: SHORTFALLS BASED UPON TIER 1 AND SUBORDINATED BUFFERS



Source: SNL, ING

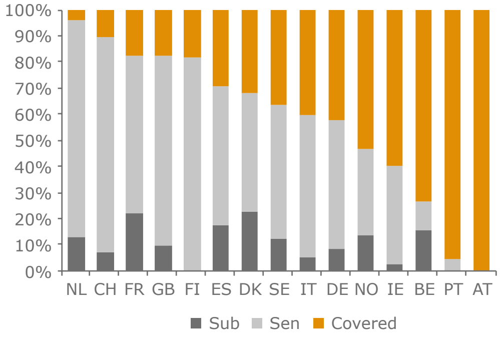
Figure 9 suggests that on average, the indicative 8% MREL requirement as well as the 6% leverage ratio linked floor, are currently more restrictive for G-SIBs than the minimum 16-20% TLAC Pillar 1 requirement and the related minimum 33% debt instrument restriction proposed by the FSB. Although TLAC requirements only apply to G-SIBs, similar requirements for non-G-SIBs, such as D-SIBs, on the other hand, seem to request buffers beyond the minimum 8% loss absorption requirement imposed by the BRRD. Most banking sectors meet neither one of the minimum requirements via their available Tier 1 and subordinated debt instruments, consequently exposing senior debt holders to bail-in risks.

When senior buffers are included, banks are obviously in better shape with regard to their bail-in buffers than suggested by the chart. That said, the analysis above does indeed support our expectation that banks will remain focussed on the issuance of bail-in eligible debt instruments at the expense of covered bonds. Sectors with sizeable senior buffers compared to their capital buffers are likely to issue more capital instruments in our view. Banks with smaller senior buffers remain motivated to enhance their senior buffers in order to disperse potential bail-in risk across a broader base of senior bond investors, as a means to maximising potential recovery on senior paper in the case of a bail-in.

CONCLUDING REMARKS ON COVERED BOND SUPPLY

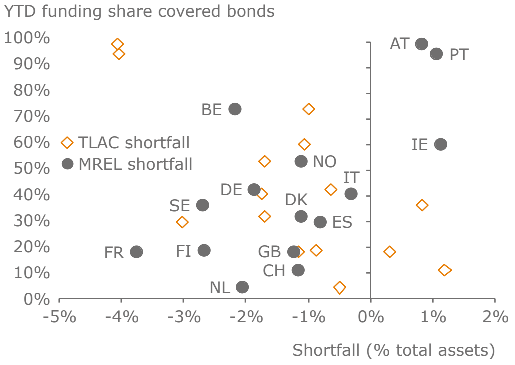
The current debt issuance focus of banks already broadly confirms the aforementioned findings. In light of the bail-in buffer levels depicted in Figure 6, it is no surprise to find the French banking sector among the sectors with larger subordinated than covered bond issuance this year (please refer to Figure 10). Nor is it odd to see a stronger preference for the issuance of covered bonds by Irish issuers.

> Figure 10: YTD funding mix distribution by jurisdiction



Source: Dealogic, ING

> Figure 11: Covered bond funding shares versus buffer shortfalls



Source: Dealogic, SNL, ING

However, at this stage the hard buffer requirements set by the BRRD seem to be a more important driver than the (proposed) TLAC requirements. Figure 11 plots the YTD share of covered bond funding as percentage of the total funding attracted by the different banking jurisdictions in relationship to the previously calculated TLAC and MREL shortfalls. Institutions from jurisdictions with comparatively lower Tier 1 and subordinated buffers as percentage of their total assets (as approximation to the BRRD loss absorption definition) attract less funding via covered bonds and vice-versa. The relationship with the TLAC shortfall points in the opposite direction. This is not surprising as the TLAC requirements are at this stage still proposals. Furthermore, the denominator effect, i.e. the differences between risk-weighted assets versus total assets (as proxy for liabilities including own funds) offers an important explanation. In light of last year's Basel Committee's proposals on risk-weighted assets, the ultimate liability management effects arising from TLAC loss absorption requirements may already for that reason converge with the applicable BRRD bail-in buffer considerations.

That said, we think it is abundantly clear that issuance prospects for covered bonds will remain affected by the banking community's focus on bail-in buffers. Furthermore, for banks the current funding cost environment is something of a sweet spot for the more expensive non-collateralised refinancing sources. Banks do well to keep their valuable collateral powder dry, rather than issuing covered bonds to obtain a few basis points cheaper funding.

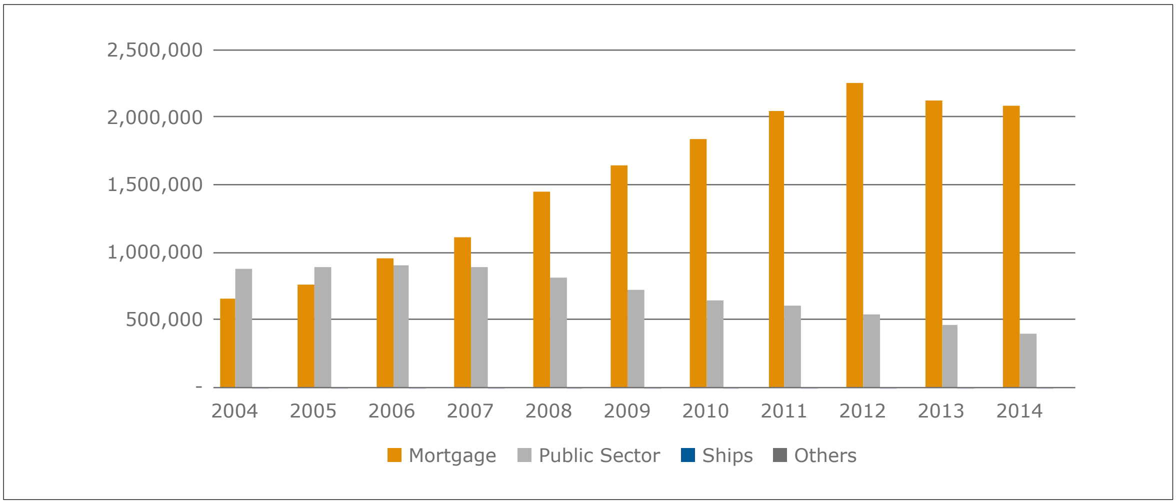
1.5 THE IMPACT OF FLUCTUATING MORTGAGE MARKETS AND COUNTERACTING REGULATORY MEASURES ON COVERED BOND ISSUING INSTITUTIONS

By Heiko Langer, BNP Paribas and Stefan Rösch, LBBW

I. THE RISE OF MORTGAGE COVERED BONDS AMID HETEROGENEOUS HOUSING MARKETS

Between 2004 and 2012 the covered bond market saw significant volume growth, almost doubling in size. The expansion was driven by the increasing issuance of mortgage covered bonds, which more than offset declining volumes on the public sector covered bond market. The volume of outstanding mortgage covered bonds first surpassed the volume of public sector covered bonds in 2006 and subsequently showed annual growth rates in excess of 10% until 2012. Interestingly, the increase in outstanding mortgage covered bonds was not primarily driven by mortgage lending volumes rising at the same pace, but rather by an increasing number of banks using covered bonds to fund already existing mortgage portfolios.

> FIGURE 1: VOLUME OF OUTSTANDING COVERED BONDS BY COLLATERAL



Source: ECBC, BNP Paribas

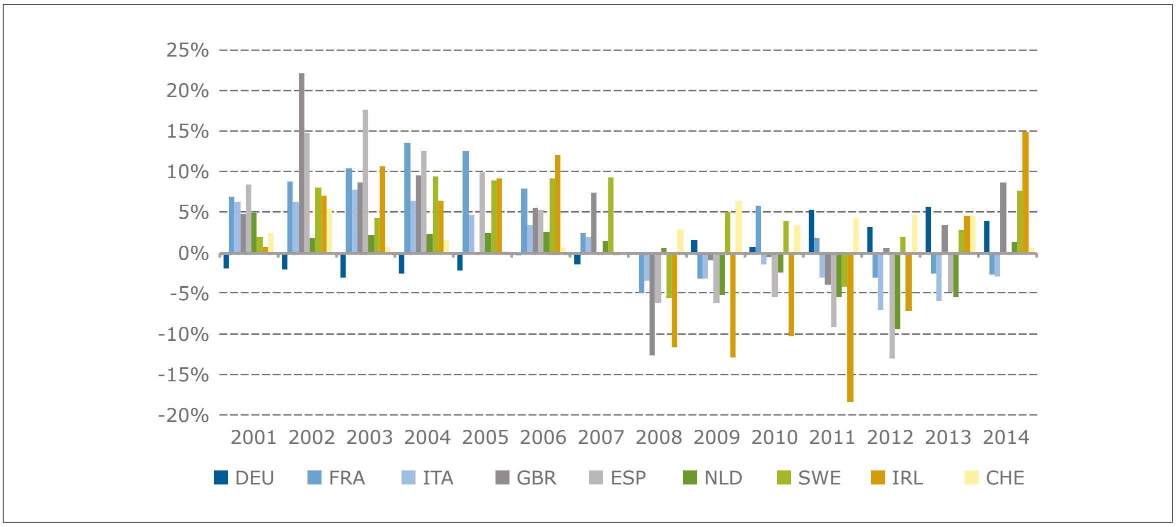
The main reason for the increasing use of mortgage covered bonds as a funding tool can be seen in the outbreak of the global financial crisis, which had a significant impact on the price and availability of other funding sources, such as unsecured debt or mortgage backed securities. The fact that issuance of mortgage covered bonds increased during a crisis that was at least partly triggered by a burst of mortgage bubbles in several countries is in itself remarkable. The best explanation for this phenomenon is that the bond market growth mainly represented a catch up move driven by countries where covered bonds had previously not been issued, rather than a cyclical development driven by an expansion of mortgage lending. Going forward, cyclical mortgage market movements are likely to have a different impact on the respective covered bond markets than in the previous crisis. It is therefore worth having a closer look at some of the driving factors of mortgage market movements as well as counteracting regulatory measures. Lastly, we look at how fluctuating mortgage markets impact covered bond issuing institutions.

II. HETEROGENEOUS TRENDS IN HOUSE PRICES IN EUROPEAN STATES

In recent years, price trends in the European real estate markets have diverged considerably. For example, while prices dropped sharply in Spain and the Netherlands, they climbed markedly higher in Germany and

Sweden. In Ireland, there have been extreme fluctuations; real prices nearly halved between 2007 and 2012, while they were up nearly 15% in 2014 – the highest rate of increase in Europe.

> Figure 2: Relative annual changes in real house prices



Source: OECD, LBBW Research

As a rule, property price bubbles develop when the construction sector decouples from the overall economic cycle and excess supply arises – as in Spain and Ireland, for example. Another aspect is the strong expansion of private debt in periods of low interest rates, resulting in a burden that cannot longer be borne when interest rates start to rise. In that case too, prices come under pressure as increasing numbers of properties are sold. This was evident in the US sub-prime crisis, for example. However, in our view, price trends in the housing markets do not merely reflect positive future expectations or a change in demand due to migration flows. Financing arrangements that have become established historically as well as institutional and regulatory parameters in the single states also exert an influence; these are in turn crucial for the range in which prices fluctuate. Below, we explain this further on the basis of examples.

III. SPECTRUM OF HOUSING FINANCE ARRANGEMENTS AND PARAMETERS

Financing arrangements are the key factor that determines the degree of volatility in housing markets. In Germany and France, it is normal for households to take out mortgage loans under which rates are fixed over a longer period. As a result, the impact of changes in interest rates is cushioned and there is also a fixed basis for calculating the monthly costs. By contrast, variable interest rates based on a reference rate determined in the capital market are dominant in the UK and Spain. While they mean that the swap rate is saved compared to a fixed rate loan, interest rate changes have an immediate effect on the payments that households have to make. In addition to the duration of the fixed rate, further adjustable parameters can be used to counter excessive price volatility in the property market at the regulatory level:

> Repayment obligations vs. interest-only loans;

> Loan-to-value (LTV) limits;

> Share of foreign currency loans;

> Tax aspects, and

> Mortgage equity withdrawals.

Rapidly rising property prices are frequently associated with an expansion of private debt. Below, we therefore cite examples aimed at steadying trends in national real estate markets and also describe general parameters that counter excessive price fluctuations. This article focuses on residential mortgage loans, since these are the dominant assets in the cover pools of mortgage covered bonds at European level.

IV. EXAMPLES OF INTERVENTION TO ACHIEVE STABILITY

Package of measures in the Netherlands to stabilise the housing sector

In the Netherlands, real property prices fell by about one quarter from the end of 2008 to the start of 2014. At the same time, Dutch households are affected by very high debt levels with mortgage loans accounting for most of the debt. LTVs of Dutch home loans are also very high compared to those in other countries. The Dutch government therefore introduced a number of reforms to counter these problems with effect from 1 January 2013. First, mortgage interest rates are now tax deductible only if a loan granted after 1 January 2013 is repaid in yearly instalments in the next 30 years. This therefore puts an end to the deductibility of interest on interest-only loans, which used to be a common funding model. Second, the redemption-free portion of a mortgage loan granted prior to 1 January 2013 may not exceed 50% of the costs of acquisition. Third, the LTV will be reduced by one percentage point every year. Starting from 105% in 2013 the target of 100% is expected to be reached in 2018. Fourth, in the case of existing loans, the tax deductible portion of the mortgage debt will be reduced by -0.5% each year as from 1 January 2014.

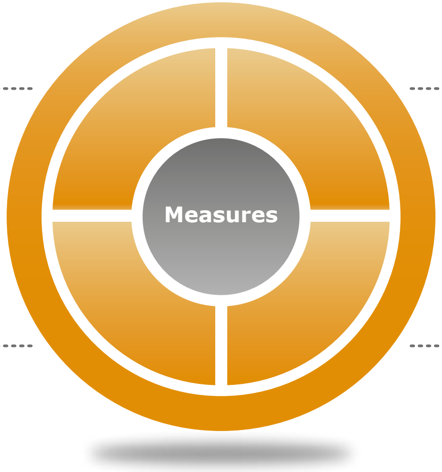
> Figure 3: Summary of measures aimed at strengthening the resilience of the Dutch housing market

Interest deductibility

From 1 January 2013 the interest charged on a loan can be claimed against tax only if the loan granted is repaid within the next 30 years annual installments.

Redemption-free period

The Redemption-free portion of the mortage loan extended before 1 January 2013 must not exceed 50% of the acquisition cost.



Tax benefit

From 1 January 2014 till 2040 the tax benefit decrease gradually of -0.5%.

Loan-to-Value (LTV)

Annual reduction in LTVs by one percentage point to the target figure of 100% in 2018 (starting from 105% in 2013).

New provisions with regard to interest deductibility and redemption-free periods constitue some of the basic requirements enabling the condusion of NHG insurance when a home loan is taken out.

Source: LBBW Research

Initiative to lower LTV ratios in Sweden to safeguard financial market stability

Besides the Netherlands, household debt levels are also high in Sweden. However, the housing market remains in a long upward trend in which real prices have nearly doubled since early 2000. With a view to securing national financial market stability, the Swedish Financial Supervisory Authority has submitted draft rules that introduce a repayment requirement for new home loans. They provide for a mandatory repayment of housing loans up to an LTV of 50%. Specifically, the annual repayment up to an LTV ratio of 70% must be at least 2% and in the case of an LTV between 70% and 50% at least 1%. Previously, the Swedish Bankers' Association had called for stricter criteria for new home loans. However, the draft regulations on the introduction of the repayment requirement were halted for the time being in April 2015, as the Swedish Administrative Court of Appeal takes the view that the legal powers of the regulators have been exceeded.

Shorter repayment periods and higher risk-weighting in Switzerland

Remarkably, outstanding mortgage loans as a percentage of GDP are three times higher than in Austria or Germany. While the Swiss tax system creates an incentive to leverage, this is not the case in the neighbouring states Austria and Germany. The reason is the net wealth tax levied in Switzerland, which is calculated on the basis of a residential property's market value less existing debt. To counter the risks to financial market stability from bullet loans with no regular repayments, the Swiss Bankers Association recently introduced a repayment requirement. In addition, the repayment period was reduced from 20 to 15 years and stricter rules for the risk- weighting of mortgage loans were introduced. Overall, the Swiss housing market is overvalued. However, macroprudential measures have already been implemented to counter lending growth.

V. EXAMPLES OF PARAMETERS AIMED AT AVOIDING MARKET FLUCTUATIONS

Pfandbriefgesetz in Germany has dampening effect on rising market values

One reason why annual property price fluctuations in Germany are comparatively moderate is the LTV, which is capped at 60% of the so-called lending value ("Beleihungswert") in the Pfandbrief Act (PfandBG). This represents the maximum amount of the loan that can be refinanced through Hypothekenpfandbriefe having regard to minimum overcollateralisation. The PfandBG makes a distinction between market value and lending value. The latter is the fundamental value of a property. This is the amount which can be realised in the market on a lasting basis and which is not influenced by economic or speculative fluctuations. These criteria result in the lending value normally being below the market value. The lending value reacts sluggishly to rising market prices due to the long-term view and the gap therefore grows during booms. If speculative influences drive market values of properties well above the fundamental lending value, only a relatively low proportion of the mortgage loan can be funded on the basis of favourable Pfandbrief conditions. As a rule, this means that credit costs rise, making speculative transactions in Germany less attractive and dampening price increases.

Full recourse of the mortgage lender against the mortgagee

In general, a country's insolvency rules play an important role in the probability that mortgage loans are serviced in a timely manner. In particular, the consequences for debtors from the creditor bank's realisation of the property serving as collateral differ from country to country – above all, when the proceeds are lower than the residual debt – which occurs primarily in periods of sharp price declines. In such a situation, the outstanding debt after return of the property is borne either by the borrower or bank creditor – depending on the insolvency rules. For example, the insolvency regulations provided a strong incentive for borrowers to pay the instalments in Spain despite the severe economic crisis in combination with a steep fall in prices in the housing market. For the first time, the amendments to the insolvency rules in Spain published on 28 February 2015 mean that a private insolvency is possible as soon as borrowers have returned their property for realisation by the lender. In the past, mortgage debt was disregarded and for private persons there was therefore a huge incentive to pay the due instalments. This was the reason why so few private persons filed for insolvency. Instead, residential mortgages – in contrast to loans to project developers – were normally serviced mostly. In our opinion, the ultimate effects of the new insolvency rules are likely to depend on whether and how frequently the above option is used. The economic situation and the labour market in Spain have at least eased somewhat of late. In our view, the risks of distortions on the real estate market are lower now.

Avoidance of mortgage equity withdrawals

Mortgage equity withdrawal options are a key feature of mortgage markets subject to a relatively low degree of regulation (e.g. UK, Sweden, the Netherlands). By contrast, this is not possible in heavily regulated mortgage markets (e.g. Germany, France, Italy). Mortgage equity withdrawal describes the volume expansion of a current real estate loan with a rising market value of the property. Ultimately, the amount of the loan collateral rises in the course of this. The additional funds can also be used for private consumption. The growing wealth from the rising market values in this case is siphoned off by the additional debt incurred. If banks apply looser lending criteria, this can lead to bubbles forming in the real estate market as a result of mortgage equity withdrawals, since more loan-funded consumption leads, ceteris paribus, to a growth in economic output.

VI. IMPACT OF FLUCTUATION OF MORTGAGE MARKETS ON MORTGAGE COVERED BONDS

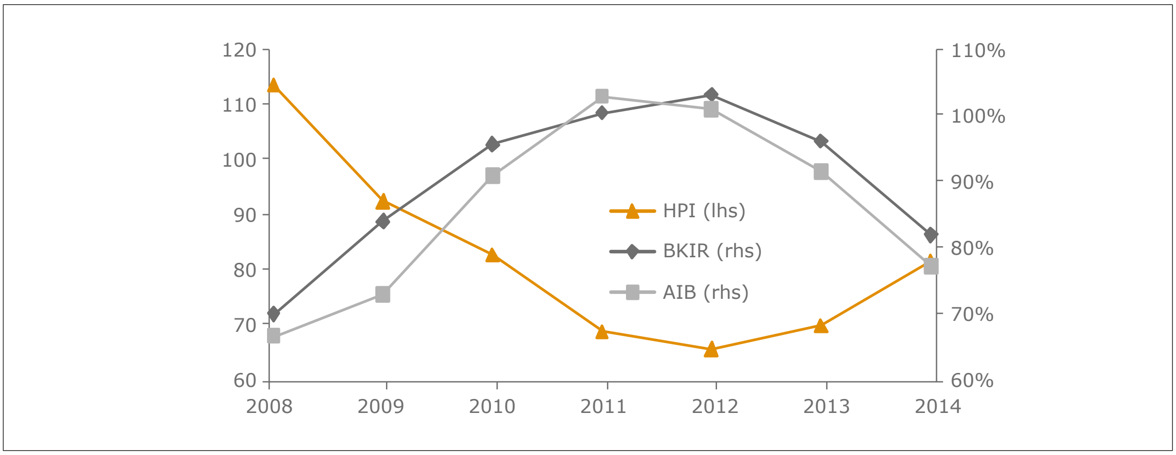
As shown above, property prices in various mortgage markets can fluctuate significantly, despite stabilising measures undertaken by regulators and governments. This in turn has a direct impact on the cover pools securing the outstanding covered bonds and their issuer. Dynamic collateralisation, which is derived from the ongoing obligation of the covered bond issuer to maintain sufficient assets in the cover pool at all times, is a key feature of covered bonds and means that the issuer has to react to certain changes occurring in the cover pool. Changing property prices have a direct impact on the LTV ratios of the mortgage loans within the cover pool. The most immediate link between changing property prices and LTV ratios within the cover pool can be observed where the relevant covered bond framework or programme documentation requires frequent revaluation through indexation. In a market of falling property prices, every revaluation through applying the updated property index value immediately leads to higher LTV levels within the cover pool. In theory, LTV levels could remain stable if the outstanding balance of the affected mortgage loans were reduced accordingly, e.g. through pre-payments by the mortgage borrower, but this is a very unrealistic scenario.

Once LTV levels surpass a certain threshold, which is typically set between 60% and 80% by the relevant covered bond framework or programme documentation, the level to which mortgage loans are recognised as collateral for outstanding covered bonds is gradually reduced. This means that the issuing entity might have to post additional collateral for the same amount of outstanding covered bonds. It can also mean the issuer faces reduced flexibility with regards to issuing additional covered bonds secured by the existing pool if the pool initially contained more collateral than was needed for the amount of outstanding covered bonds. The impact of moving property prices on LTV ratios can be less immediate where the framework or programme documentation requires less frequent adjustment of property prices. However, changing property prices may still cause rating agencies to adjust the levels of required over-collateralisation that covered bond issuers need to provide in order to stabilise the covered bond rating. As a result, the flexibility to issue additional covered bonds secured by an existing pool may be impacted through rating agency requirements, even though the issuer has not yet carried out a revaluation of underlying properties.

A good example to illustrate the connection between property price movements and LTV ratios within a mortgage cover pool can be found within the Irish Mortgage ACS market. As we have seen above, Ireland has seen significant price movements within its property market within recent years. At the same time, issuers of Irish mortgage ACS are required to revalue the underlying property of the mortgage assets on a quarterly basis using a property price index. Residential mortgage assets within the cover pool only count as collateral up to 75% of the value of the underlying property.

After Irish property prices peaked in the autumn of 2007, they went into a steady decline, which lasted until early 2013. Since then, Irish property prices have started to increase again. At the same time, the weighted average indexed LTV of the mortgage cover pools of AIB Mortgage Bank and Bank of Ireland Mortgage Bank moved in the opposite direction, peaking at or close to the low of the property price development before declining again during the recovery phase of the Irish housing market.

> FIGURE 4: IRISH HOUSE PRICE INDEX VS. WEIGHTED AVERAGE INDEXED LTV LEVELS OF AIB AND BKIR

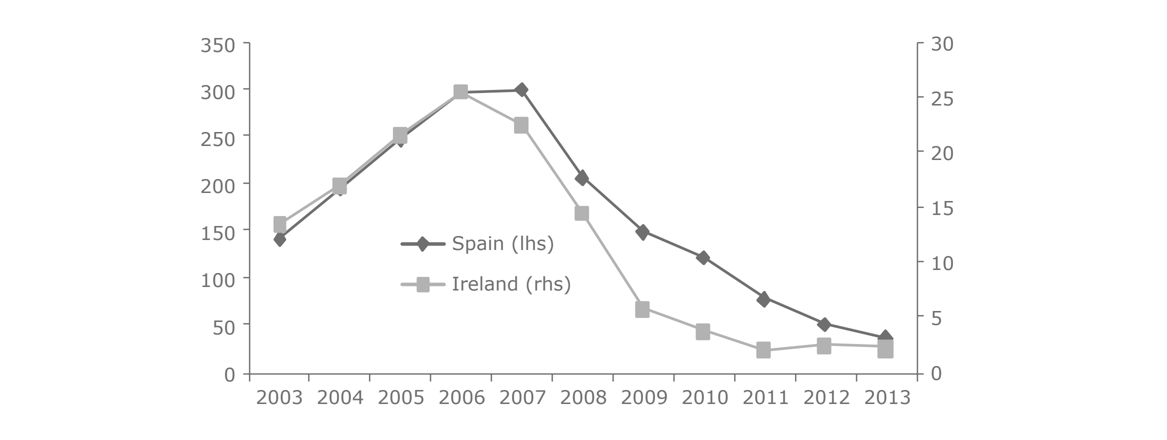


Source: AIB, BKIR, Bloomberg, BNP Paribas

LTV developments of mortgage cover pools can deviate from the property price cycle, if the composition of the cover pool changes. Especially in a downturn of the mortgage market where the issuer is required to add additional collateral to the pool, the increase in average LTV ratio within the pool can be slowed down, if the newly added loans have a lower LTV ratio than the ones already contained in the pool. Mortgage loans with lower LTV ratios could also come from existing unencumbered portfolios held by the issuer outside the cover pool that had a relatively low LTV ratio at the beginning of the downward cycle. Such loans would have typically been originated at the beginning of a positive property price cycle, whereas mortgage loans originated at the end of a positive cycle tend to quickly develop above average LTV ratios once property prices start to fall.

Another source of unencumbered mortgage loans with moderate LTV ratios can be found in the new lending activities of the issuer, as newly originated mortgages are based on up to date property price valuations. However, a housing market downturn usually is accompanied by a decline in mortgage lending volumes, due to subdued demand for new mortgage loans and stricter lending criteria. This can make it difficult for mortgage lenders to source enough additional mortgage collateral in the primary market to meet the increased collateralisation requirements. Mortgage lending activities in Ireland and Spain dropped significantly during the market downturn that started in 2007.

> Figure 5: New Irish house loans and Spanish new mortgages created



Source: Department of the Environment, Community and Local Government (Ireland); Instituto Nacional de Estadistica (Spain), BNP Paribas

In case an issuer is unable to provide enough additional eligible mortgage collateral, substitute assets can be used to provide the required level of over-collateralisation for the outstanding covered bonds within the limits of the respective covered bond programme or framework. Adding substitute assets will, however, have no impact on the average LTV ratio of the cover pool as such assets are likely to consist mainly of claims issued or guaranteed by governments.

Providing additional collateral increases the level of asset encumbrance within the issuer's balance sheet, in particular if existing unencumbered assets are moved within the issuer's balance sheet to the cover pool. If the issuer acquires new assets in order to increase the level of collateralisation of the covered bonds the impact on encumbrance is less pronounced, as the ratio of secured liabilities to total liabilities falls in this scenario. However, the additional funding required for the new assets comes with increased cost. While not all mortgage market downturns trigger a systemic banking crisis, there is a risk that decreasing investor risk appetite could lead to an increase in funding costs for banks in general and specialised mortgage lenders in particular in such a scenario. This in turn would increase the cost of providing additional collateral to compensate for higher LTV ratios within the cover pool, as the additional collateral would have to be funded on an unsecured basis.

VII. CONCLUSION

The obligation to increase collateralisation levels within the cover pool in a market downturn, where new loan generation may be low and unsecured funding cost for over collateral particularly high, clearly represents a pro-cyclical element that can put additional stress on an issuing entity. At the same time, dynamic collateralisation is a key design feature of covered bonds which is crucial for their ability to withstand the ups and down of a mortgage cycle. The principle of dynamic collateralisation also highlights the importance of the issuing entity and the full recourse that covered bondholders have to it. While these features are unable to fully absorb the effects of volatility inherent in mortgage markets, they provide a level of stability to covered bonds that has helped to build the reputation of the asset class.

Despite a broad arsenal of counteracting measures available to regulators, one can assume that volatility in mortgage markets will prevail. Unprecedented levels of low interest rates have taken us into unchartered territory. However, a different sensitivity to interest rate fluctuations across Europe due to varying institutional frameworks is likely to impact mortgage markets heterogeneously. The main problem of counteracting measures is time delay, which means that greater extremes can be prevented, but unexpected market movements cannot be avoided.

1.6 EXTENDABLE MATURITY STRUCTURES – THE NEW NORMAL?[1]

By Franz Rudolf, UniCredit and Karsten Rühlmann, LBBW

Just a few years ago, extendable maturity covered bond structures were the exception rather than the rule. However, analysts and rating agencies increasingly focused on the valuation of liquidity risks and thus refinancing risks in the wake of the financial crisis. By making structural adjustments to their programmes, issuers were able either to mitigate the related risks or transfer them in their entirety to investors. In addition to soft-bullet structures, where extension periods are typically 12 months, conditional pass-through structures with much longer maximum maturities have also increasingly gained ground in the last two years.

Below, we take a closer look at current developments of covered bonds with extendable maturities and examine the motives of issuers on the one hand and the reactions of investors on the other.

WHAT ARE THE MAIN DIFFERENCES BETWEEN THE REDEMPTION REGIMES?

The most fundamental idea of covered bonds is safeguarding a steady flow of payments to investors following an issuer event of default. Once the issuer ceases to exist, the cash-flow stemming from a separate portfolio of assets is used to cover all claims due to bondholders. The two most significant sources of risk threatening the ability to satisfy the claims are (i) credit default risk, which potentially leads to an over-indebted cover pool and (ii) market risk – first and foremost in the form of liquidity risk – which potentially leads to a sufficiently large cover pool, which, however, is no longer able to satisfy claims due to illiquidity.

In the past, the rating agencies and other market participants assumed that, following issuer default, the cover pool administrator could easily monetise the assets in the cover pool either by disposing parts of the cover assets or in an indirect way, i.e. by bundling them into an asset-backed security (ABS) or – if applicable – by using the refinance register. Some covered bond structures may also be able to raise new debt either in a technically "unsecured" way or even in the form of covered bonds. In particular against the backdrop of uncertainty regarding the functionality and the efficiency of these tools, it is particularly important that the cover pool administrator is equipped with many options so he is free to pick the most efficient one.

In cases involving hard-bullet structures, issuers try to enhance the effectiveness of the tools by regularly calculating pre-maturity tests or by maintaining a certain amount of liquid assets in the cover pool – a costly exercise for issuers since liquid assets usually come with a negative carry. Soft-bullet structures that have a limited extension period (usually one year) aim to manage the liquidity challenge at the expense of investors. However, since the soft-bullet timeframe might still turn out to be insufficiently long, the idea of pass-through aims to completely eliminate any refinancing risk by eliminating pressure to sell assets at the expense of a maximum timeframe for the payment deferral.

In a nutshell, the three major redemption regimes for covered bonds work as described below:

> **Hard-bullet covered bonds:** payments have to be made when due according to the original schedule. Failure to pay on the Standard Maturity Date (SMD) triggers default of the covered bonds, and the covered bonds accelerate.

> **Soft-bullet covered bonds:** payments have to be made when due according to the original schedule. Failure to pay on the SMD as a consequence of an issuer default does not trigger covered bond default. The extension period grants more time (typically at least 12 months) to repay the covered bonds, setting a new Final Maturity Date (FMD). Failure to pay on the FMD triggers default and acceleration of the covered bond.

[1] The views expressed in this article are those of the authors only.

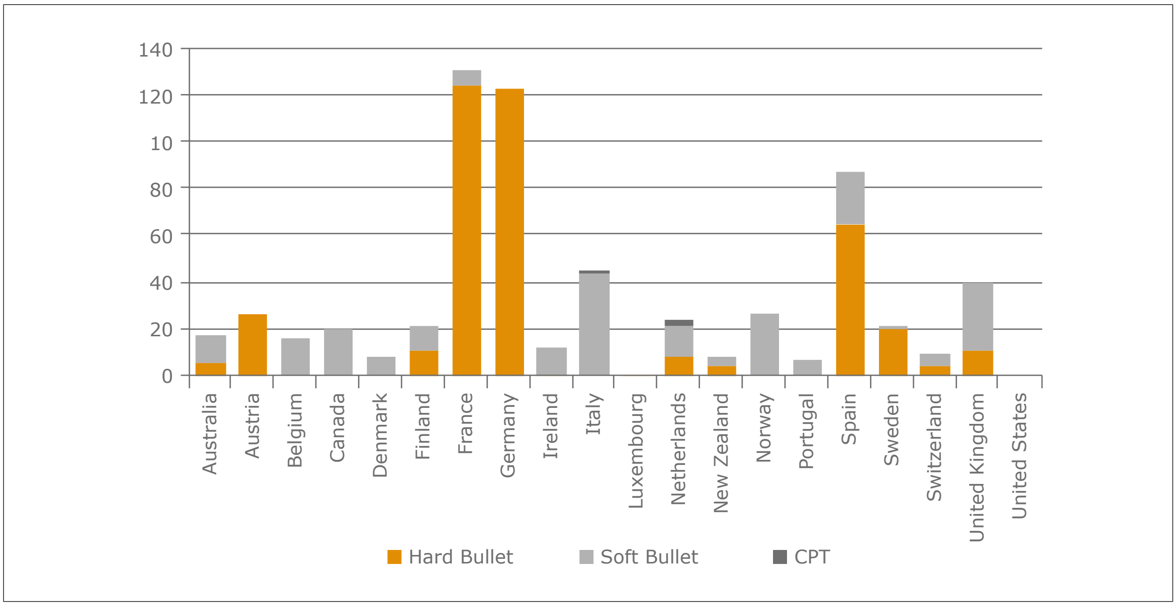
- **Conditional pass-through covered bonds (CPTCB):** payments have to be made when due according to the original schedule. Failure to pay by the SMD as a consequence of an issuer default does not trigger default of that covered bond. The affected covered bond goes into pass-through mode. All other outstanding covered bonds are not affected and would only trigger the pass-through mode one after another if they are not redeemed on their respective SMDs.

Are pure hard-bullet jurisdictions becoming a rarity?

Extendable maturity structures should now be on the lips of all investors. Covered bond jurisdictions in which only hard-bullet covered bonds are issued are rare in the meantime. A glance at the iBoxx € Covered benchmark index reveals that Germany, Austria, Luxembourg and Spanish single cédulas are now exceptions. In all other jurisdictions, soft-bullets, or to some extent conditional pass-through covered bonds, are now quite normal. And in the last 12 months, we have seen several further developments.

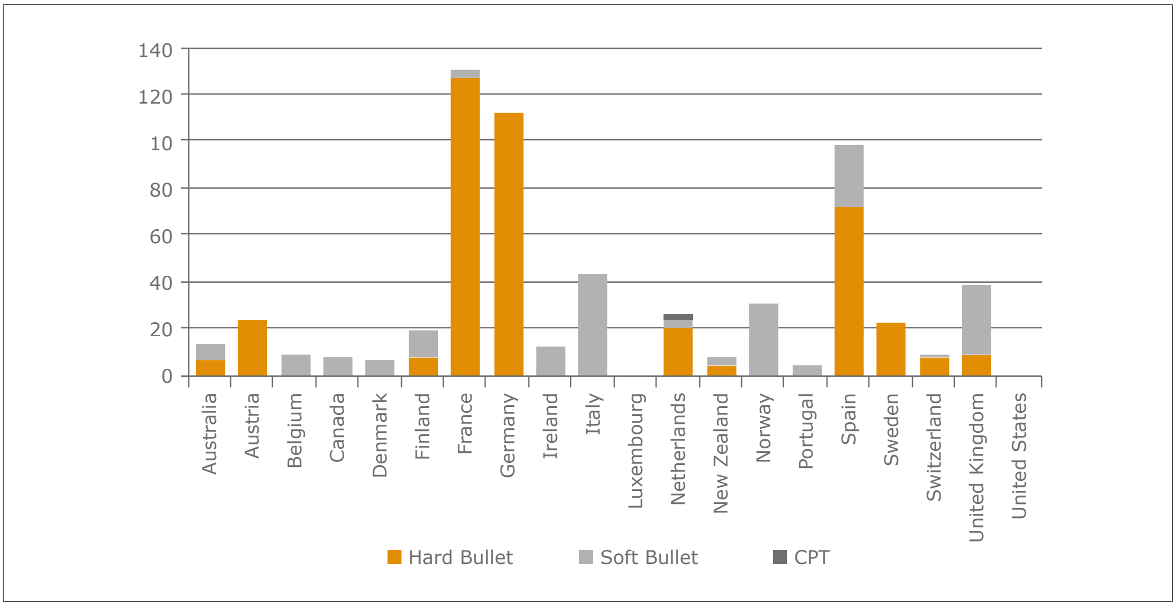
A comparison of maturity structures at the end of April 2015 with the previous year shows that the proportion of extendable structures has risen by nearly 5% to 37.5%. There were major shifts especially in Switzerland, the Netherlands and France with soft-bullets. In case of CPTCB structures with Unicredit SpA and Van Lanschot, two new issuers entered the market and Banca Monte dei Paschi di Siena proposed the conversion of its soft-bullet programme to conditional pass-through.

> Figure 1: Distribution of EUR benchmark covered bonds by maturity profile as of April 2015



Source: Markit, institutions, LBBW Research

> Figure 2: Distribution of EUR benchmark covered bonds by maturity profile as of April 2014



Source: Markit, institutions, LBBW Research

Current developments at the market for soft-bullets

In Switzerland, at the start of April 2014, UBS came to the market with its first soft-bullet covered bonds. In September 2014, it was followed by Credit Suisse, which a few months later came up with a new idea in the covered bond market. At the end of November 2014, the bank arranged for its bond creditors to vote on whether to convert existing covered bond issues from a hard-bullet to a soft-bullet structure. Investors that approved the conversion were to receive a premium of 5bp on their outstanding nominal. To carry out a successful conversion, the issuer required a quorum of 75%. In addition, 75% of the participants had to consent to the new maturity structure. If the majority was not reached, it was possible to arrange a second investor meeting, at which only at least 25% of all bondholders had to attend. Once again, 75% of participants were required to consent to the conversion. After only one covered bond was converted in the first vote, the issuer obtained approval for the remaining bonds in the second round. As a result, all outstanding benchmark covered bonds of Credit Suisse now have a soft-bullet structure. However, in the second vote a private placement of EUR 600 m maturing in July 2039 was no longer considered; it therefore still has a hard-bullet structure. Credit Suisse and UBS have had the option to issue soft-bullets in their base prospectuses for quite some time.

ABN Amro chose a similar procedure at the end of February 2015. The institution sought to convert ten outstanding covered bonds from hard- to soft-bullets. A premium of 5bp was also offered for a positive vote. Unlike in the case of Credit Suisse, the necessary quorum was just two thirds for the first meeting and one third for any second round of voting. At least two thirds were required to consent to the change in both votes. After the institution obtained approval for just six tranches in the first round, bondholders consented to the conversion of the remaining four covered bonds at the second attempt in early April. Since setting up its programme in 2005, ABN Amro has had the option under the terms of its prospectus to issue soft-bullets in the future. However, it was first necessary to amend the prospectus, which took place in December 2014. The private placement issues still have a hard-bullet format. After the amendment to the prospectus, two soft-bullet private placements were issued. Another Dutch institution, ING Bank, has also announced intention to issue soft-bullet bonds in the future. The registration at the Dutch Central Bank for the EUR 5bn programme was completed at the start of April 2015. At the same time, an initial EUR 0.5m test issue was carried out. In contrast to other banks, ING has decided to continue both its hard- and soft-bullet programmes to offer more transparency for its investors and also to have greater flexibility in covered bonds issues. ING's documentation has included the option to issue soft-bullets since it initiated its first covered bond programme.

The share of issuers with extendable maturities has also grown in France. In the past, only Axa Bank Europe had soft-bullets outstanding under its SCF programme. In November 2014, Crédit Agricole followed as the first SFH issuer with such a structure. Further soft-bullet issues followed from Société Générale (SFH) in February, HSBC France (SFH) in March and La Banque Postale in April. A glance at the base prospectuses shows that all institutions had the option to issue covered bonds with extendable maturities in most cases since the initiation of the programmes. Only Société Générale added such a paragraph to its programmes in 2013. Apart from the programme of Credit Mutuel-CIC, the other SFH programmes enable soft-bullet structures to be issued. As a result, it is quite conceivable that such bonds will account for a larger share of future issues in France. In the SCF programmes, aside from Axa Bank Europe, only Société Générale's programme currently offers the option to issue paper with extendable maturities.

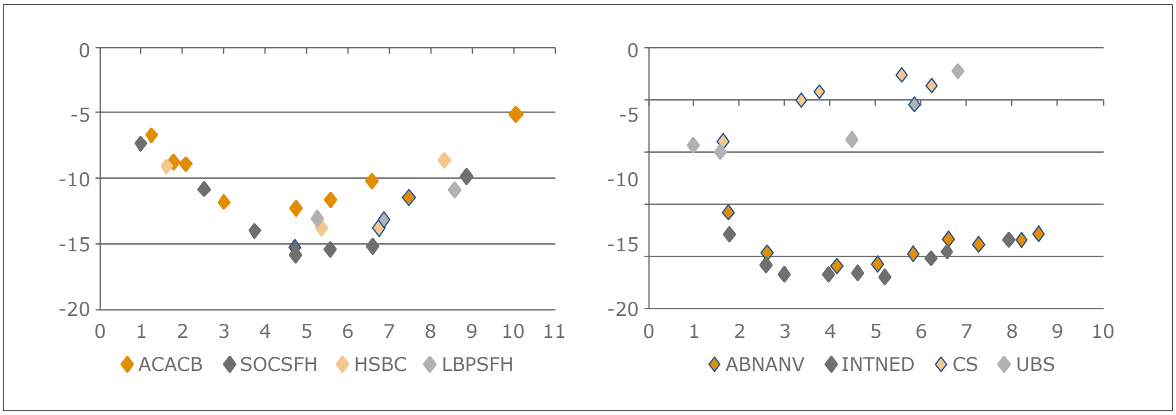
In October 2014, Swedish Covered Bonds Corporation (SCBC) became the first Swedish covered bond issuer to come to market with a soft-bullet issue. The institution has kept open the option in its programme documentation since 2006. Among the other Swedish issuers with outstanding benchmarks, only Stadshypotek AB has such a passage in its base prospectus, although it was added only in November 2014.

All the soft-bullet issues referred to above have 12-month extension periods. The extension interest rate is variable and is based on the 1-month Euribor plus a spread based on the issue spread in most cases. This is above the issue spread of 1bp only in the case of SCBC (26.3bp).

Still no signs of any marked differentiation in spreads

An analysis of the issuers under consideration still shows no evidence of any marked spread differentiation between soft- and hard-bullet covered bonds. One would expect investors to demand higher spreads for the risk of a maturity extension. However, the analysis reveals that the spreads of soft-bullet bonds (edged in dark blue) are even trading slightly below their trend line in most cases. Even in the jurisdictions in which outstanding paper has been converted, there are no signs that investors are differentiating to any great extent. The issues of ABN Amro and ING Bank, which currently has only hard-bullets outstanding, can be used as a benchmark. Both have identical issuer ratings (Moody's A2 / Fitch A / S&P A). The asset swap spreads of the ABN soft-bullets are slightly higher than those of ING. However, this slight pickup existed even before the conversion was announced and accordingly no major widening has taken place.

> Figure 3a & 3b: Asset swap spreads soft-bullet covered bonds vs. hard-bullet covered bonds



Source: Markit, Bloomberg, LBBW Research

The lack of spread differentiation by investors also suggests that issuers are increasingly switching to soft-bullet structures largely for reasons of costs, especially as such structures offer further benefits. They are treated preferentially by rating agencies with regard to lower overcollateralisation requirements. Moreover, the fact that liquidity can be managed more easily also plays an important role. For example, in jurisdictions such as the Netherlands, pre-maturity tests have to be carried out in the case of hard-bullet issues. These involve certain rating requirements. In addition, a certain amount of liquidity must be maintained for the maturities of the next 180 days, which results in additional costs.

Conditional pass-through structures gain momentum

In 2013, conditional pass-through structures were introduced in the covered bond benchmark universe. NIBC was the pioneer issuing a EUR 500mn 5Y benchmark covered bond in October 2013, followed by further benchmark issues in April 2014 and April 2015. While for the first two years, conditional pass-through structures were widely discussed but remained a niche product, it was just in 2015 that this redemption format gained momentum. Additional issuers took the conditional pass-through path with UniCredit SpA joining in February 2015 with a EUR 1bn 10Y OBG, van Lanschot Bankiers bringing its inaugural EUR 500mn 7Y benchmark in April 2015 and Banca Monte dei Paschi di Siena being in the process of converting its programme to conditional pass-through at the time of writing (June 2015).

In CPTCB programmes in general, following an issuer event of default, any repayments, including early repayments and excess spread, remain with the cover pool until a covered bond series reaches its SMD. Following an issuer default, a particular covered bond will only become pass-through once a covered bond reaches its SMD and the available cash is insufficient to fully redeem the bond. Other outstanding covered bonds will not turn into pass-through covered bonds as long as they are paid as scheduled. It goes without saying, that the switch to pass-through on the SMD does not prevent the cover pool administrator from trying to sell assets in order to improve the liquidity of the cover pool and, in so doing, making the switch to pass-through less likely. The maturity extension and switch to pass-through aims to reduce refinancing risk, i.e. the risk of fire-sales. In order to generate sufficient cash flows to repay the covered bonds due, the cover pool administrator is empowered to sell a randomly selected part of the asset portfolio as long as the conditions of the amortisation test are met.

Following issuer default, the amortisation test has to be passed. The amortisation test is designed to ensure that cover assets are sufficient to repay the outstanding covered bonds. Key aspects in that respect are the level of overcollateralisation in the programme as well as provisions to address transactions risks like servicing. If the test is failed, all covered bonds become pass-through. In this case, the covered bond company will be required to use all funds available to redeem all covered bonds on a pro rata basis, while interest continues to accrue on the unpaid part of the covered bonds.

An important feature in the CPTCB is the minimum overcollateralisation (OC), which is needed to allow for the programme to switch to pass-through. Shortage of collateral, which could arise from paying administrative costs as well as covering potential credit losses, would otherwise instantly trigger a failure of the amortisation test and an acceleration of payments to bondholders. This is the reflection of the fact that cover pool credit risk is the key remaining source of loss in the cover pool asset-liability-management. In order to eliminate market risk completely, the legal final maturity is extended to beyond the maturity date of the longest asset in the pool. In the case of NIBC, this extension period is 32 years, in the case of UniCredit SpA it is 38 years and in the case of van Lanschot 32 years.

PASS-THROUGH VS. SOFT-BULLET

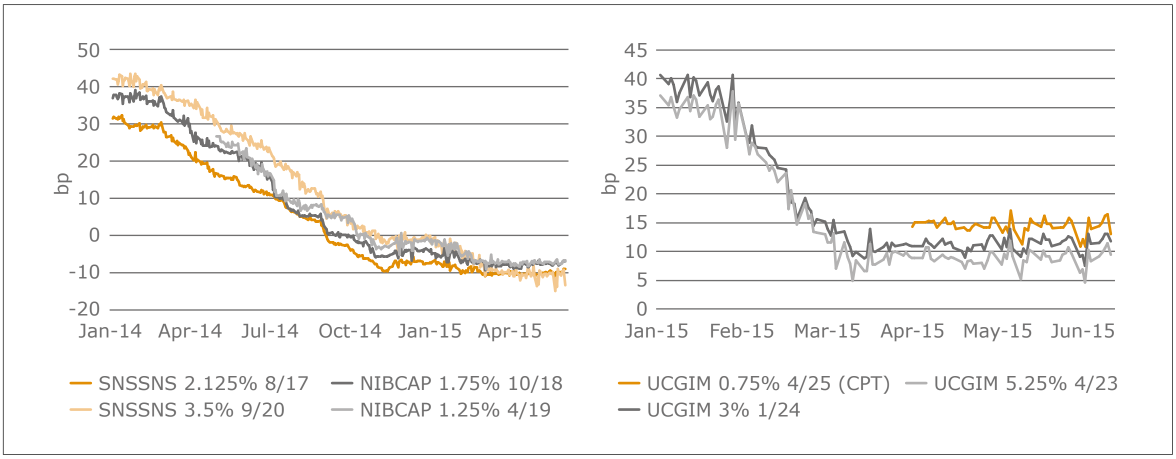
The decisive difference between soft-bullet redemption formats and (conditional) pass-through formats raises the question of the length of the deferral term. The longer the deferral period of the soft-bullet payment regime, the closer the two redemption formats become. The remaining differences are not essential and could be replicated in any case: the (implicit) SARA clause that e.g. NIBC posts is also frequently found in soft-bullet structures. Thus, during the deferral period, the scope of actions taken by each cover pool administrator is quite similar: both will not hold on to an unnecessary amount of liquidity but will instead use it to partially redeem the deferred principal amount. Furthermore, both will try and find opportunities to liquidate assets (in line with the SARA clause) in order to allow redemption to occur as quickly as possible.

However, the one-year deferral period of most soft-bullet covered bonds provides the cover pool administrator with a relatively limited timeframe in which the required amount of cover pool assets can be liquidated. In contrast, the opportunities in a (conditional) pass-through case are technically unlimited. Hence, market risk is mitigated with soft-bullets covered bonds and eliminated with CPTCBs.

Issuers’ perspective

Issuers currently find themselves in complex situations: At the peak of the sovereign debt crisis, quite a few issuers were seeking funding by retaining transactions which should have been used to collateralise European Central Bank (ECB) open market operations. The ECB applies two different haircut schedules for covered bonds: one for those rated A- or higher and another less-favorable one for those rated in the BBB-range. Non-investment-grade covered bonds do not qualify. However, during the crisis, country ratings in the periphery dragged down the senior unsecured ratings of banks, which, in turn, resulted in lower covered bond ratings. In addition, quite a few assumptions of rating agencies, regarding the legal frameworks, market environment, refinancing cost, foreclosure periods of cover assets, etc., changed for the worse and, therefore, made it necessary for issuers to post ever-higher overcollateralisation. Taking a look at the agencies’ analyses of cover pool losses, it appears as if there was a unanimous view that the most significant source of losses was market-related rather than credit-related. Hence, eliminating market risk instantly reduces overcollateralisation requirements by a significant share. This means that issuers are either able to issue more covered bonds against the same amount of collateral and/or are able to achieve higher ratings for their covered bonds with the same amount of overcollateralisation – in any case, a massive increase of efficiency for the entire covered bond funding exercise.

> Figures 4a & 4b: Pricing comparison of CPT-structures vs. soft-bullet structures



Source: UniCredit Research

Usually, one would expect an increase of (funding) efficiency to carry at a positive price. Since the investors accept a greater deal of uncertainty regarding the repayment date without claiming default, one might expect a slightly higher spread for the CPTCB compared to a bullet bond.

However, when comparing NIBC as an CPTCB issuer with SNS – carrying similar senior unsecured ratings and issuing soft-bullet covered bonds – the spread difference between conditional pass-through and soft-bullet appears negligible (see Figure 4a). With the CBTCBs NIBC 18 at ms-8bp and the NIBC 19 at ms-7bp, the two bonds trade some 4-6bp richer than what would be considered a fair SNS spread for the same duration. A similar picture evolves when comparing UniCredit S.p.A.'s two OBG programmes (see Figure 4b), with marginal spread difference rather relating to duration than to different formats. Hence, from the point of view of a mere funding spread, the efficiency gain currently comes almost for free. However, this is just the pure refinancing cost side. If the total administrative package taken into account, the conditional pass-through format generates less ALM necessities, lower need for derivative transactions and lower need for holding liquid assets, which usually generate negative carry. The only element that remains on the "cost side" for issuers is that opting for conditional pass-through format currently is still not a common format in the covered bond universe and not all investors are yet familiar or comfortable with it, thus reducing the potential investor base – in particular, since it is more efficient to opt for a pass-through format the lower the senior unsecured rating (or anchor rating) becomes.

Investors' perspective

Before going into the details of comparing various redemption formats, it is vital to depict the critical point in the life-cycle of a covered bond. Assuming they have the same issuer and identical collateral pools, the cash flows of a hard-bullet, soft-bullet and CPTCB are identical as long as the issuer does not default. In case of an issuer default, the cash flows of either redemption format are still identical if the available cash retained in the cover pool is sufficient. The only "interesting" case from an investor's point-of-view is in the case of (i) insufficient liquidity – because this when a bullet covered bond is prone to default – and a pass-through will start to defer payments or (ii) of insufficient collateral – because this is the case when all series of a covered bond programme, irrespective of the repayment regime, accelerate and become due.

The following considerations are based on the investment decision between a bullet covered bond and a CPTCB of the same issuer out of two different programmes but based on cover pools that have exactly the same risk characteristics.

Several investors seem to have problems with the very long final maturity date of CPTCBs which can substantially exceed the scheduled maturity. Therefore, they prefer hard-bullets, which carry the obligation to be repaid on the SMD. However, while there are structural differences between the redemption regimes, arguably many of these differences blur quite a lot upon a closer look.

The total damage of any adverse event can be split into a probability of the occurrence of the adverse event and the impact it has once it occurs – the critical question an investor has to answer is whether the adverse event is a deferral of payments or the technical default of an investment. In a hard-bullet case, both events happen simultaneously, while, in a soft-bullet case, and even more so in the case of a CPTCB, the events drift apart.

First, we take a look at investors that consider the technical default of a claim more adverse than a payment deferral. In case of a default, the results in terms of cash-flows are quite likely to be similar for both cases, bullet and conditional pass-through. The result in a bullet case would, quite likely, be a creditors' meeting to decide how to treat the leftovers: fire sale or natural amortisation; result unknown ex ante. Thus is the case for a CPTCB; the roadmap is clearer in the CPTCB since there is an ex ante definition of what is about to be done. All bonds fall due and natural amortisation of the collateral will be split pari passu unless a bondholders' meeting votes for something different. The difference comes in the form of the likelihood of the adverse "default" event. In both bullet and pass-through cases, a default could be triggered by asset-quality deterioration and, therefore, in both cases the issuer ex ante would have to post the same amount of overcollateralisation for the same result of assessed credit risk. However, precautionary measures to address liquidity risk in the cover pool have to be performed by the issuer of bullet covered bonds only. Whether or not the liquidity buffer turns out to be sufficient can only be assessed ex post. In other words, any liquidity buffer is nothing but a suboptimal hedge for liquidity risk. By way of aligning the cash flows from the cover pool to the covered bond investors, CPTCB issuers perform the only existing perfect hedge against liquidity risk. Therefore, the likelihood of a default of the covered bond is lower for the CPTCB. Consequently, an investor that is sensitive to a default of a claim as opposed to being sensitive to payment disruption should rather be focused on CPTCB.

An investor that is rather sensitive to payment disruptions apparently has the opposite rationale. In case of the occurrence of the payment disruption, the impact is probably quite similar irrespective of the payment regime (see rationale above). It might be the case that the net present value of the recovery payment is higher in a bullet regime due to a self-selection of the investor base; investors that fear a payment disruption might rather be inclined to vote for a shorter recovery period at the expense of a slightly lower nominal recovery rate. Investors that decided to invest in a CPTCB might be inclined to maximise nominal recovery at the expense of a longer recovery period. The true difference appears when considering the likelihood of the adverse event "payment disruption". Credit driven occurrence would be similar in both repayment regimes, whereas the likelihood of a liquidity-driven occurrence is much higher for the CPTCB due to the fact that liquidity-driven default-precaution is passed on to investors in the form of the negative event "payment deferral". In the bullet case, the liquidity-driven default-precaution comes in the form of additional overcollateralisation requirements/liquidity buffers. The liquidity buffers certainly are no perfect hedge against the occurrence of the adverse event "payment deferral" but are certainly better than taking no precautions.

However, given the important role covered bond ratings play nowadays within the regulation framework and in cooperation with central banks (e.g. spread-risk factors under Solvency II, CRR risk-weightings, liquid asset classification under LCR rules, ECB repo haircuts), risk aspects are not the only drivers of an investment decision. Rating-sensitive investors would benefit from the higher and more stable rating of the CPTCB. However, empirical evidence does not indicate significantly tighter spreads of CPTCB compared to slightly lower-rated covered bonds. In our view, this partly reflects the current overall compressed spread environment as well as the fact that some investors cannot buy conditional pass-through transactions due to internal restrictions. As we mentioned above, the likelihood of a payment deferral might be larger than that of a bullet case. Therefore, the uncertainly regarding duration might increase without compensation in form of higher yield. The benefit comes in the form of the investment being more suitable for the regulatory challenges constraining investors in many respects.

> Figures 5: Overview of key aspects in conditional pass-through structures

	Pros	Cons
Issuer	Collateral efficiency by reduced OC requirements	
	Less ALM necessities	
	Higher covered bond rating and less dependency on issuer rating level	
	Overall increased funding efficiency	
Investor	Higher covered bond rating and less dependency on issuer rating level	Lower OC levels
	Higher rating stability	Uncertain final redemption date
	Higher expected recovery rate	Increased complexity in analysing structures
	Same regulatory treatment as bullet formats	

Source: UniCredit Research

Rating agencies' perspective

Rating agencies' methodologies have changed quite substantially in the past few years. Recalling Moody's plain and simple rating methodologies for covered bonds back in 2003/04, when covered bonds were all rated 2/3 notches (for mortgage and public covered bonds respectively) above the senior rating, which later was expanded to 4/5 without big analysis supporting it, life has become more complicated. However, analysis is also more precise and detailed from an academic point of view. The step-by-step analysis of assessing issuer credit risk followed by the assessment of legal/regulatory/market related etc. aspects, and finalised by the assessment of the credit risk/liquidity risk etc. of the cover pool, was a milestone. Starting from the joint default basis, the degree of detail of rating agencies' analyses increased exponentially. The high end of complexity is probably to be found in the analysis of the cost of raising liquidity against a static cover pool in a post insolvency situation. This necessitates an assessment of potential funding sources, assumptions on amounts that need to be raised, valuation adjustments and, last but not least, assessment of the role and the abilities of the cover pool administrator running the matter after issuer insolvency. Against this backdrop, rating agencies have unsurprisingly welcomed the new development regarding CPTCBs. Default risk is essentially reduced to credit-risk-driven events.

S&P explicitly stated that conditional pass-through structures can help reduce risks, thereby adding to the stability of its covered bond ratings. CPTCBs reduce, in particular, the asset-liability mismatch risk, which typically contributes more than two-thirds to S&P's overcollateralisation requirements. Fitch stated that its covered bond methodology, a covered bond programme with no asset-liability mismatch risk, can be rated on a de-linked basis from the issuer. This is because there should be no obligation to liquidate cover assets at any cost, thereby removing the majority of payment interruption risk for covered bonds after an issuer default and leading to a discontinuity risk profile that is more in line with amortising structured finance transactions. The reason that Fitch has not entirely delinked the CPTCB rating from the issuer rating – in contrast to structured finance (SF) transactions – is because covered bonds allow for significantly more flexibility regarding cover pool composition and issuance capacity than typical SF transactions.

Moody's stated that CPTCB can remove refinancing risks effectively. Thus, the credit quality of CPTCB can be much less dependent on, or even independent of, the supporting bank's credit strength. However, the type of structure that the issuer decides to use will determine the degree to which the programmes can effectively mitigate refinancing risk. Moody's identified different mechanisms that lead to different levels of mitigation for refinancing and time subordination. The level of overcollateralisation at deal inception is a key parameter in this respect. Even in CPTCBs, a fire-sale of the cover pool at high discount rates might occur, if OC levels are insufficient and as the breach of certain test, e.g. the amortisation test, may lead to an event of default. Additional key elements are the evaluation of swap agreements, servicing and counterparty risks as well as legal risks (set-off risk, commingling risk, claw-back risk).

CONCLUSION

Covered bonds with extendable maturities are becoming more and more common on the covered bond market. In the meantime, you can find them in almost every covered bond jurisdiction. The largest share goes to soft-bullets where extension periods are typically 12 months. Another interesting addition to the existing soft- and hard-bullet structures are CPTCBs. In most scenarios, the cash flows of the various redemption profiles would be similar, all else equal. In a worst-case scenario, after issuer default and in a situation where their cover pool is not sufficiently liquid, CPTCB promise a lower nominal loss at the expense of investors accepting a potentially much longer deferral period compared to those of hard-bullet and typical soft-bullet structures. Hence, investors have to make up their minds, which adverse event they are more inclined to accept, i.e. payment deferral or technical default. From a regulatory perspective, CPTCB offer higher ratings and higher rating stability. The higher complexity, as well as the fact that CBTCB could switch into pass-through mode, and their very long theoretical final maturity dates, represent a big hurdle for many investors. But instead of this, we have seen a higher acceptance for both – soft-bullets and CBTCB – in the last few months.

1.7 GREEN AND SUSTAINABLE COVERED BONDS

By Wolfgang Kälberer, Association of German Pfandbrief Banks & Chairman of the ECBC Fact Book Working Group
and Frank Will, HSBC & Chairman of the ECBC EU Legislation Working Group

I. INTRODUCTION

A changing conscience regarding social responsibility and sustainability of the society are main drivers for the development of more sustainable properties and real estate markets. It is obvious that energy consumption and carbon dioxide (CO2) emissions produced by real estate represent important factors in the climate change debate. There is a clear move towards the creation of a 'Green Buildings' market complying with certain energy efficiency standards as well as social and environmental criteria. Green buildings are not a new phenomenon, politicians at national and international levels increasingly focus on sustainability aspects of real estate, developing tailor made instruments to improve the energy efficiency and environmental characteristics of new buildings and – through the retrofit of existing buildings – the building stock.

The creation of more sustainable property markets immediately triggers the question of how to finance energy efficiency and green buildings. Several initiatives have been set up to address this concern. The development of new financial instruments for more sustainable purposes is a global challenge. The United Nations Environment Programme (UNEP) Finance Initiative triggered a dedicated work stream on finance at G20 level, part of the G20 Energy Efficiency Action Plan. It is suggested that covered bonds could provide long-term finance to sustainable assets such as energy efficiency investments.

At European level, the European Union (EU) has set the goal of reducing CO2 emissions by 20% by year 2020, in comparison to 1990. More precisely, the European Commission – DG Climate Action is currently assessing how to shift private finance towards climate friendly investments. In this context, the private stakeholders' based Climate Bonds Initiative promotes a large and liquid green and climate bonds market through a bonds certification scheme.

As regards mortgage business, public and private capital could be channeled into green and sustainable mortgages which would comply with a certain set of sustainability standards. Indeed, covered bonds could be used for this purpose and would then be labeled – under certain requirements – green covered bonds. Such an instrument has the potential to create a new large market segment and unlock a new investor base. Green covered bonds could be developed as a funding instrument tailored to the needs of green bond investors.

It is therefore worthwhile to explore possible standards of a green and sustainable covered bond. As green covered bonds are supposed to refinance green mortgages as cover assets, a definition of a green mortgage would be required.

II. GREEN MORTGAGES

Mortgages used to finance green buildings could be labeled 'green mortgages'. It is important to note that there is no single generally recognised definition of a green building or green mortgage. The European Group of Valuers' Associations TEGoVA provides in its European Valuation Standards (EVS) 2012, page 174 the following definition:

"A green or sustainable building uses resources such as energy, water, materials and land more efficiently than other buildings and produces less waste and fewer emissions and potentially offering a better internal working environment".

The concept of sustainability itself is far from being precise when applied to buildings which themselves vary enormously in design, construction and use while different users will have their own concerns which may change over time. There is evidence that the approach to define 'green buildings' might be different as regards commercial and residential property.

Commercial real estate

The sustainability features of commercial properties are usually assessed through certification and rating tools. There are around 30 voluntary rating systems worldwide that try to meet the conceptual complexity of the term 'sustainability'. As a sample, green building certificates are delivered by BREEAM (Building Research Establishment Environmental Assessment Method), LEED (Leadership in Energy and Environmental Design) or DGNB (Deutsche Gesellschaft für Nachhaltiges Bauen).

It is true that these certificates and/or labels are not fully comparable because they are based on different requirements and use non-standardised parameters for energy consumption and other sustainability features. The strength of certification systems is based on their horizontal approach as they not only measure lower energy consumption but take also environmental, economic and socio-cultural criteria into account. For example, sustainability certificates also address water and waste management, material use or tenant health and safety. With such an approach, they prove to be more comprehensive and meaningful as regards the level of sustainability of buildings compared to the Energy Performance Certificates (EPCs), only focusing on the energy performance of buildings. The EPCs have to be delivered for every new built property since 2006.

The emergence of a true 'green buildings' market in commercial real estate is still hampered by the relatively low market penetration of certification systems. There is evidence that the market share of certified green commercial properties is to be situated in the low single-digit percentage points. It is also apparent that most of the green commercial real estate is concentrated in metropolitan markets and consists to a large extent of new or heavily renovated buildings.

However, it is likely that this situation will quickly evolve. Investors, users as well as regulators focus more and more on the need to build green buildings and to retrofit existing buildings into sustainable properties. Therefore, it is likely that sustainable real estate will become the market standard in the medium to long-term and that the sustainability labels will develop more uniform standards.

Whereas labels and ratings represent useful tools for measuring the sustainability features of commercial property, thus providing an appropriate tool for the selection of green commercial buildings, the situation is considerably different as regards residential property.

Residential real estate

As the above-referenced certification and ratings tools are tailor made instruments for commercial properties, they do not apply to residential real estate. A definition of green mortgages for residential properties should rely on what is the most tangible tool in this market. Therefore, the only way to define green residential buildings consists of using EPCs in accordance with Directive 2010/31/EU of 19 May 2010 on the Energy Performance of Buildings.

It is true that the EPCs only cover energy efficiency, disregarding a wider range of sustainability aspects. But in residential real estate, energy consumption and associated emissions are the most tangible sustainability features available. Due to the mandatory introduction of the EPCs by the Energy Performance of Buildings Directive, energy data is most readily available for each singe residential unit in the EU. Energy consumption covers lightening, room heating, cooling, warm-water production and energy for pumps and fans.

A pan-European approach to define green mortgages on the basis of EPCs meets two challenges: the first is to describing the energetic quality of the buildings in a consistent way. There are many ways of describing these qualities such as the final energy demand (expressed in kWh/m2), the energy efficiency class (A,B,C etc.), the energetic level of the building (passive house, zero-energy building etc.) or the degree of compliance with national minimum standards.

The second challenge consists of making these criteria comparable. The methodology of calculating the energy performance of buildings differs on a country-by-country basis as well as the range of sustainability criteria be covered by the methodology. The weight allocated to specific sustainable aspects is defined at Member State level and therefore differs across the EU.

Similarly, the classification of building types into different building categories is not consistent across all Member States. A major obstacle to compare the EPC's across countries is based on evidence that the allocation of the energy ratios to the different energy efficiency classes is not the same in each Member State. Thus, an energy efficiency class of 'A' does not necessarily correspond to an energy demand of 25-50 kWh/m2 in each Member State.

A consistent EPC-based pan-European definition of green mortgages would therefore require a mapping exercise of the different national energy efficiency scales and classes. A green mortgage definition could then be attached to a green building displaying an EPC with an energy efficiency class of 'C' at the least. This would encompass an energy demand of 100kWh/m2 maximum and basically covering all new built residential properties in the EU and those which were subject to a larger energetic modernisation.

III. SUSTAINABLE AND GREEN COVERED BONDS

Dedicated covered bonds could be an appropriate instrument to refinance green mortgages. The emergence of such a 'green covered bond' offers interesting prospects since the overall green bond market has been booming since 2013. Most institutional investors are introducing sustainability criteria into their investment strategies. Against this background, an increasing investor demand for diversification in different green bond structures can be expected.

The development of a sustainable and green bond market provides a wider range of approaches. One option could be to put more emphasis on environmental, social and governance criteria (ESG Principles). Another option consists of focusing more on the funding of green buildings in a stricter sense. But the funding of green buildings by covered bonds is not a plain vanilla exercise, it triggers further questions: Would it be sufficient to build a green covered bond concept only on certified or green labeled properties, i.e. without further requirements? How to identify green buildings within a cover pool which is by definition a dynamic structure and does not allow for the creation of green buildings' subclasses?

The first 'sustainable or green Pfandbriefe' issued by Münchener Hypothekenbank e.G. and Berlin Hyp AG provide some evidence at that respect. Both institutions shared a similar approach by choosing an independent second party opinion (sustainability rating agency oekom research) for the labeling of the respective issues in order to provide transparency and credibility to the market.[1]

Münchener Hypothekenbank issued an 'ESG-Pfandbrief' along the lines of the Green Bond Principles in order to refinance social housing cooperatives committed to affordable and user-friendly housing. The focus of this approach was definitely more on social rather than environmental criteria. The ESG-Pfandbrief complied with strict requirements regarding the use of the proceeds from the issue, the process of project evaluation and selection as well as the management of the proceeds and reporting. The Pfandbrief was then labeled by the oekom research as compliant with the ESG principles.

Berlin Hyp decided to focus more on the funding of green buildings. But the above bespoke green building certificates for commercial properties were only considered as the primary eligibility criterion. Additional sustainability criteria were to be met in order to deliver a green label to the respective covered bonds. They were delivered by the Green Bond Framework as defined by the oekom rating agency[2] and most notably address environmental and social components which are not taken into consideration in a satisfactory way by green building certificates, if at all.

[1] oekom research second party opinion, see http://www.gruener-pfandbrief.de/startseite.

[2] oekom research, annex 1 to the second party opinion referenced under FN1.

According to this Framework, environmental components cover environmentally harmful building materials, resource consumption, emissions and waste. Social criteria address healthy and safety of tenants and other building users, working conditions on renovation worksite and supply chain standards for renovation materials. Finally, controversial business activities in the buildings are excluded.

In order to secure the allocation of the proceeds coming from the issuance of covered bonds to the green buildings, the issuer is supposed to sign up to the two commitments. The first commitment ensures that the existing cover pool will always include green assets for an amount at least equivalent to the net proceeds. The second commitment implies that the issuer commits to reallocate funding to eligible green assets for an amount equivalent to the net proceeds of the green Pfandbriefe until their maturity date.

The final layer of requirements for a green covered bond consists of transparency, documentation and reporting. Issuers of sustainable and green covered bonds have to provide investors as well as bond labeling agencies with regular information about the loan structures of mortgage cover pools, the amounts and maturity structures of loans dedicated to the funding of green assets in the pool, property types, their certification level etc.

IV. THE MARKET PERSPECTIVE: GREEN AND ESG COVERED BONDS

Over the last few years, green and sustainable bonds have been a fast growing capital market segment. The first issuers of green bonds were supranational issuers such as the European Investment Bank (EIB) and the International Finance Corporation (IFC)/World Bank. Since then a wide variety of corporate and agency issuers as well as local and regional authorities have entered the market. In 2014, roughly USD38bn of green bonds were issued by about 70 issuers and 2015 should become another strong year in terms of green bond supply. In line with the growing issue volumes, investors have become more comfortable with green bonds and their underlying definitions. However, there is still a need for further standardisation of the product and for improving transparency to ensure the integrity of the asset class. The Green Bond Principles – which have been developed by issuers, investors and intermediaries in close cooperation with the International Capital Market Association (ICMA) – are an important step into the right direction as they provide guidance for both issuers and investors and should help to further promote the mainstream acceptance of the green bond market.

Green and ESG covered bonds

As already outlined above, in the covered bond space, Munich Hyp was the first issuer of an ESG covered bond. The EUR300m 5-year mortgage Pfandbrief was launched in September 2014. In April 2015, Berlin Hyp followed with its inaugural green mortgage Pfandbrief which had a benchmark size of EUR500m and a maturity of seven years.

Munich Hyp: Munich Hyp uses the proceeds of its ESG Pfandbriefe to refinance loans to housing cooperatives in Germany. The funds are employed to purchase, build and improve the energy efficiency of housing and maintain housing for socially disadvantaged sections of the society. However, it is important to note that ESG covered bond investors rank pari passu with other mortgage Pfandbrief investors and do not have a preferential claim on the ESG assets in the cover pool of the issuer.

According to Munich Hyp, its inaugural ESG Pfandbrief back in September attracted many new investors. About one third of the deal was allocated to new investors that buy only ESG bonds and have never bought covered bonds from Munich Hyp in the primary market before.

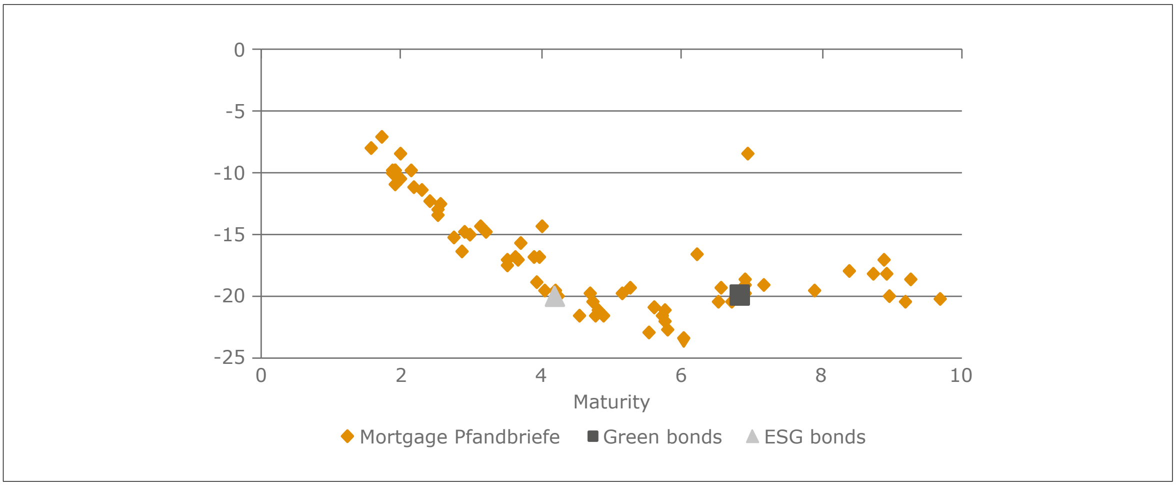
Berlin Hyp: In April 2015, Berlin Hyp issued its inaugural green Pfandbrief. In contrast to Munich Hyp's ESG Pfandbrief, the deal was a genuine green covered bond and reached benchmark size (EUR500m). The issuer stated in its press release that the deal attracted many new investors and that 48% of the issue was placed with sustainable investors.

Berlin Hyp committed to use the proceeds of its green Pfandbrief for the financing of 'green buildings' in Germany, France, the UK, the Netherlands and Poland. These assets are included in Berlin Hyp's 'normal' mortgage Pfandbrief cover pool and the Green Pfandbrief – in line with the treatment of Munich Hyp's ESG Pfandbrief – will rank pari passu with the other mortgage Pfandbriefe of the issuers. In case of issuer insolvency, investors will have a claim against the entire cover pool without having a preferential claim on the green cover assets over and above other 'normal' mortgage Pfandbrief investors.

Do green or sustainable bond trade tighter than other covered bonds?

In terms of spreads, the market does not distinguish between green and sustainable bonds on the one hand and 'normal' covered bonds on the other hand despite the larger investor base of the former. The new issue levels of Munich Hyp's ESG Pfandbrief as well as Berlin Hyp's green covered bond were not substantially tighter than those of a 'normal' Pfandbrief transaction and both deals also trade more or less in line with the other German mortgage Pfandbriefe (see Figure 1). This likely reflects the fact (i) that the green and sustainable (covered) bond market is still in its infancy and (ii) that the generally spread environment is very compressed. Moreover, the fact that from a risk perspective the cover pool assets backing the Pfandbriefe are identical for ESG/green covered bonds and 'normal' mortgage covered bonds in case of issuer insolvency plays probably also an important role.

> FIGURE 1: SWAP SPREAD LEVELS OF GREEN & ESG BONDS VS OTHER MORTGAGE PFANDBRIEFE



Source: HSBC, Bloomberg (as of 3 July 2015)

V. CONCLUSIONS

The markets for green buildings are still emerging and many aspects yet uncertain. But experience shows that sustainable or green covered bonds will attract new investors or change investor behavior as conviction increases that being environmentally and socially responsible – as well as encouraging good global governance – is important to the future of investments.

The green and ESG investor base is growing fast and several large institutional investors have already switched parts of their investments portfolios into green and sustainable assets. This trend should continue and the covered bond industry would be well-advised to prepare for this shift in investor behavior. The supras & agency sector and even the corporate sector have already jumped on the bandwagon. Other covered bond issuers should follow the example of Münchener Hyp and Berlin Hyp to ensure that the covered bond market remains attractive for a very broad range of investors.

It is true that the measurement and comparability of sustainability criteria are complex and often hardly possible. At present, investors do not seem disposed to accept lower returns for their green investments. The same applies to the finance side where banks are not supposed to accept lower interest rates for green loans nor authorities to agree on a more favorable regulatory treatment of green mortgages.

On the other hand, available market evidence suggests that saleability and let-ability of green buildings improve compared to traditional real estate. Similarly, total operating costs seem to be 5-10% lower for green buildings than those for non-sustainable properties. Thus, during a building's lifetime, the savings on so-called ‘life-cycle costs' could be substantial.

The funding of green commercial properties through green covered bonds builds on three layers, the first being a certified green building, the second the compliance with additional environmental and social criteria and the third consisting of extensive documentation and reporting requirements. All three layers are embedded in a second party opinion of an agency materialising in a green bond label.

A variety of options are available to contribute to a new sustainable covered bond market. Thus, sustainable covered bonds can also be designed on the basis of ESG-Principles where rating agencies approve and label the bonds as ESG compliant. Again, a second party opinion confirming the compliance with ESG-Principles seems to be crucial for the success of the instrument.

It is doubtful whether such a complex approach can be copied to green housing or residential mortgages. The only tangible available tool in housing markets is the EPC being now mandatory for all residential properties in the EU. A practicable approach would be to define green residential mortgages on the basis of properties which can be classified within a certain range of energy classes, possibly between energy classes A to C.

There are good reasons to believe that a third party opinion would also be required for the labeling of green covered bonds funding green residential properties. Being solely based on the energy performance of residential property, additional property-specific environmental and social criteria might be difficult to assess. But compliance with energy efficiency requirements, the use, management and allocation of the proceeds coming from green covered bonds to eligible energy efficient housing are fundamental for the green labeling of the bond and must therefore be verified by a third party.

There is evidence that a new green covered bonds market segment in Europe has great potential to develop. Over the longer term, non-energy-efficient housing and non-certified green commercial buildings will be flawed and probably struggle to remain in markets.

1.8 PUBLIC SECTOR COVERED BONDS – REFINANCING LOCAL PUBLIC SECTOR INVESTMENTS AND EXPORT LOANS

By Ralf Berninger, Caisse Française de Financement Local

INTRODUCTION

The public sector covered bond market has witnessed a profound transformation over the past ten years. Overall issuance volumes have steadily declined and at the same time, business has become more focussed on financing local public sector investments as core activity.

In addition, use of public sector covered bonds to refinance export credit loans has become more widespread over recent years even though volumes remain significantly below volumes backed by local government loans.

I. FINANINCING LOCAL GOVERNMENT INVESTMENTS

Local government: responsible for close to 60% of european public sector investments

Local and regional governments (LRGs) exercise a wide range of responsibilities across Europe. Important differences exist from one country to the other. However, the following areas are to a large extent under the responsibility of the local public sector in most of Europe:

> Local and regional infrastructure, including large parts of the local and regional rail and road network;

> Large parts of the primary and secondary education system;

> Basic services such as drinking water supply, sewerage, waste collection and treatment;

> Urban planning and development;

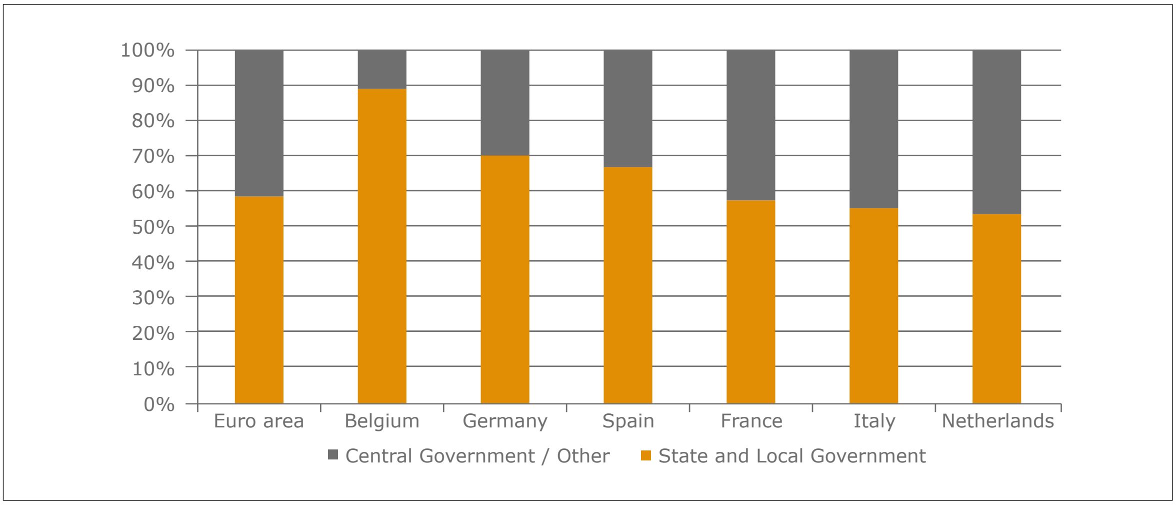
> Parts of the public health care system;

> Public order and safety, for example municipal police forces or fire-fighting services;

> Social housing in some European countries.

These responsibilities include key areas for public investments. As a consequence, local public sector investment expenditures exceed central government investments by a large margin. On average local and state government contribute close to 60% of total public sector investments across Europe.

> Figure 1: Local and state government share of total public sector investments 2014

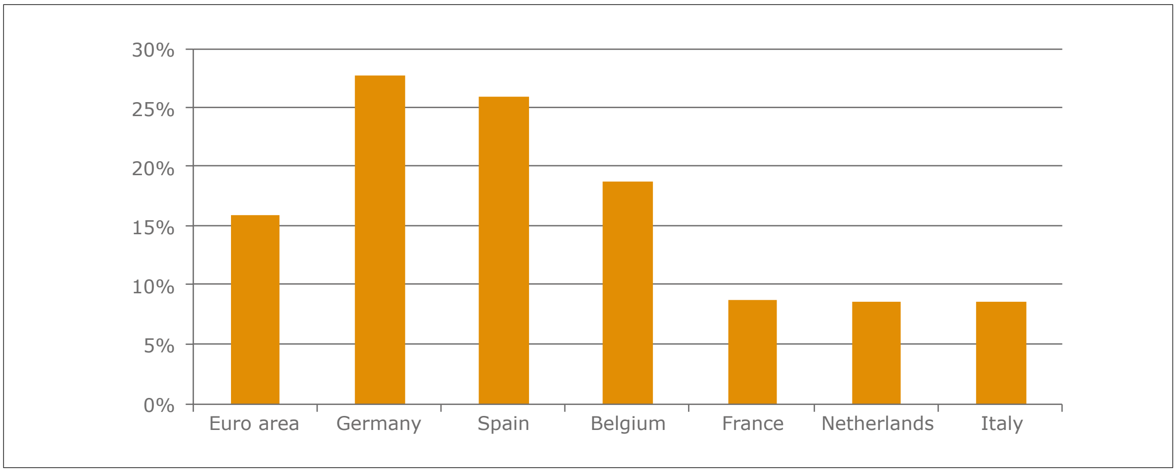


Source: Eurostat

Important differences exist with respect to budget rules for the local public sector from one country to the other. However, the principle of the golden fiscal rule applies in one form or the other across most of Europe. This rule implies that local authorities are prohibited from running deficits to finance operating expenses, new borrowing is only authorised to finance investments.

As a consequence of the strict budget rules, local and regional authorities only contribute a relatively small share to total public sector debt and deficits in Europe. Total euro area local public sector debt represents 16% of GDP. Important differences exist from one country to the other. At one end of the spectrum, local and regional government (LRG) debt in countries such as Germany and Spain with a high degree of decentralisation also represents a relatively high share of total government debt. At the other end of the spectrum, local authority debt represents less than 10% of public sector debt for countries such as France and the Netherlands.

> Figure 2: Local public sector state of general government debt 2014



Source: Eurostat

II. FUNDING SOURCES FOR LOCAL PUBLIC SECTOR INVESTMENTS

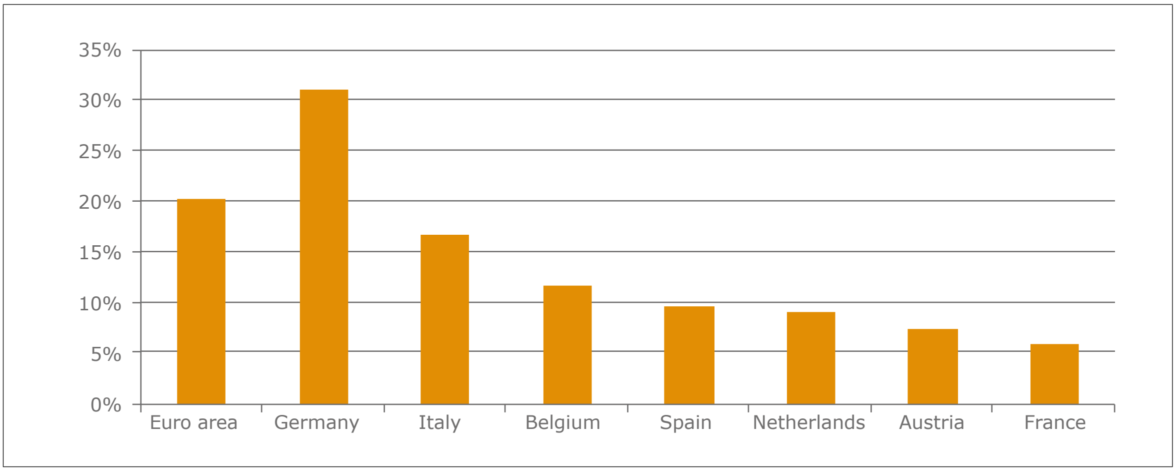
Direct bond issuance as source of funding for local authorities – only an option for larger local authorities

Direct bond issuance covers a significant part of local authority funding needs. At the end of 2014, bonds issued directly by local authorities represented above 20% of outstanding local authority debt within the eurozone.

However, the local authority bond market is to a large extent dominated by the German Länder with sufficient funding needs for regular bond issuance. At the end of 2014, bonds issued by local and state government in the euro area stood at EUR 328 billion and German issuers represented more than 75 % of this market segment.

Elsewhere in Europe, bond financing plays a much lesser role as small funding needs by bond market standards and the need for amortising structures prevent most local authorities from raising funds directly via the bond market. Whereas a third of outstanding German sub-sovereign debt has been financed via bond issuance, this figure is below 10% for markets with smaller local authorities such as France or the Netherlands.

> Figure 3: Outstanding bonds as percentage of total local and regional government debt 2014



Source: Eurostat, Bloomberg

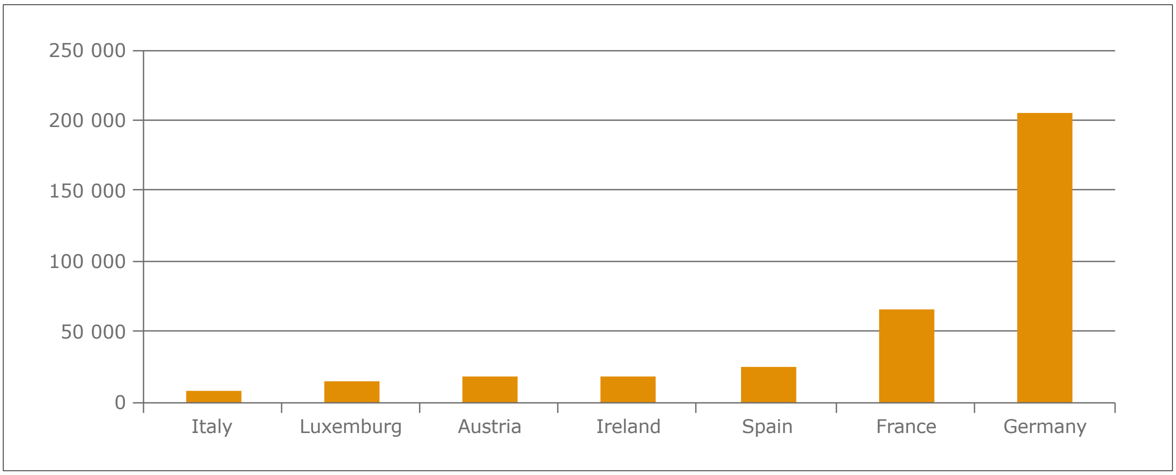
The loan market as key source of funding for local government investments

With bond issuance covering only one fifth of local government funding needs, smaller and medium sized local authorities rely on the loan market to finance investments. Covered bonds play a key role as a refinancing instrument for local public sector loans.

Funding provided by covered bond issuers

Covered bonds are used as refinancing tool for local authority loans in Germany, France, Austria, Spain, Belgium and Italy. Germany and France are by far the largest markets in terms of issuance volumes. In addition, public sector covered bond markets exist in Ireland and Luxemburg although local public sector funding needs in these two countries are small.

> Figure 4: Outstanding public sector covered bonds in EUR billion as of 31.12.2014



Source: ECBC

The outstanding volume of public sector covered bonds has witnessed a steep decline over the past 10 years. The volume of outstanding bonds has declined by around 50% to EUR 465 billion in 2013 compared to EUR 894 billion in 2005. However, public sector covered bonds can refinance a wide range of public sector exposures and not exclusively local government loans.

Special factors like the cost of German re-unification and the end of guarantees for the German Landesbank sector contributed to an initial steep increase and to the subsequent decline in public sector covered bond issuance volumes over the past two decades.

The traditional lending business to municipalities has been much more stable than the overall issuance volumes suggest. As an illustration, exposures by German Pfandbrief issuers to German municipalities stood at a total level of EUR 65 billion at the end of 2014, compared to a level of EUR 70 billion in 2008, i.e. a reduction by 7%. This compares to a decline by close to 50% in the public covered bond market over the same period and an even larger decline in outstanding German public sector Pfandbrief volumes.

For this reason, declining outstanding volumes in the public sector covered bond market do not necessarily indicate a decline in importance of covered bonds as refinancing instrument for local public sector investments. The volume of local government loans refinanced via covered bonds provides a much better indication of the importance for the sector.

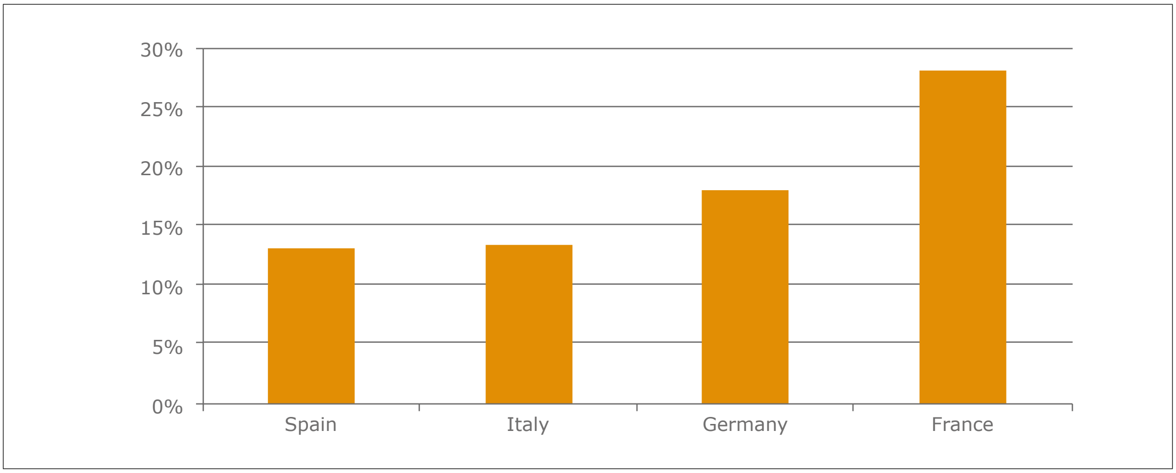
Loans to the local public sector are reported by covered bond issuers via the publication of cover pool data. Overall, the largest exposures concern German and French local authorities with respectively EUR 145 billion and EUR 53 billion in local public sector loans refinanced by covered bond issuers. This corresponds to 18% of German local authority debt refinanced via covered bonds and 28% for the French market. It is also possible to exclude local government bond issuance to estimate only the share of the loan market refinanced via covered bonds. For the German public sector, an estimated 26% of local government loans are refinanced via covered bonds, for French local authorities 30% of loans are refinanced via covered bonds.

> Figures 5: Reported covered bond issuer exposures in EUR billion by covered bond issuer country (31.12.2014)

		Germany	Spain	France	Italy	Austria
Local and state government exposures	**Germany**	144759	0	511	0	0
	Belgium	1887	0	252	0	0
	France	1519	0	51562	0	0
	Italy	3305	0	7181	8157	0
	Netherlands	131	0	0	0	0
	Austria	2729	0	197	0	12084
	Spain	5059	30336	693	0	0

Source: ECBC Covered Bond Label National Templates (BIIS, Caixabank, BBVA, CFF, CAFFIL, SG SCF, Arkéa SCF), Pfandbriefforum and vdp

> Figure 6: Estimated share of local and regional government debt refinanced via covered bonds (31.12.2014)



Source: Eurostat, vdp, ECBC, Covered Bond Label

III. PUBLIC SECTOR COVERED BONDS AS REFINANCING INSTRUMENT FOR EXPORT LOANS

Market still relatively small compared to covered bonds backed by local government loans

A number of programmes have been set up over recent years to refinance Export Credit Agency loans (ECA loans) via the issuance of public sector covered bonds. Issuance is still relatively small compared to covered bonds backed by local authority loans. This can mainly be attributed to two reasons:

(1) The export credit market is much smaller than the local authority loan market. For France, local government debt with a volume of EUR 188 billion in 2014 represents roughly three times the volume of loans covered by French export credit insurance at EUR 64 billion. For Germany, the volume of outstanding export credit insurance stood at EUR 88 billion in 2014 compared to local government debt above EUR 800 billion, and

(2) Covered bond programmes backed by export credit agency loans have often been set up more recently than programmes backed by local authority loans.

New developments should lead to increased issuance

As of today, the market is dominated by French issuers with two programmes exclusively refinancing ECA loans and two more programmes refinancing both local government and ECA loans, but there has also been issuance under Pfandbrief format. The creation of one additional French programme exclusively refinancing ECA loans has been announced in 2015. Export loans covered by export credit insurance represent public sector risk and are refinanced by the export bank via issuance of covered bonds. Programmes will often refinance both local public sector loans and ECA loans to be more cost efficient and to achieve critical size for regular issuance.

Issuance has been relatively low compared to covered bonds backed by local government loans. As an illustration, outstanding bonds of the two French programmes exclusively backed by ECA loans currently total EUR 5 billion against outstanding French public sector covered bonds close to EUR 70 billion at the end of 2014.

However, over recent years legal frameworks in France (‘garantie rehaussée’) and Germany (‘Verbriefungsgarantie’) have been adapted to the needs of covered bond issuers with the possibility to add an additional state guarantee for the benefit of the refinancing bank. The guarantee is unconditional and irrevocable and designed to complement export credit insurance cover. It provides protection for covered bond investors from:

> Any risks that may be linked to the export credit contract not covered by export credit insurance, and

> A default of the export bank.

Issuance of covered bonds backed by ECA loans is likely to increase in the future, in part thanks to the improved guarantee mechanism. In addition, the French State has announced the creation of a mechanism open to all banks active in the French export credit business, based on covered bonds as refinancing instrument. The setup, with state owned development Bank SFIL at the center, will serve as refinancing platform for French export credit loans making use of the ‘garantie rehaussée’ framework. Cover pool assets will benefit from an unconditional and irrevocable French State guarantee.

CONCLUSION

The volume of outstanding public sector covered bonds has seen a significant decline over the past 10 years. However, the reduction in volumes has been linked to a reduction in the scope of business. The underlying local authority lending business has been relatively stable. Local authorities in countries with active public sector bond markets rely to a large extent on the covered bond market to finance investments.

Public sector covered bond issuance backed by ECA loans has been very limited up to now. Nevertheless, a new guarantee mechanism and increasing volumes in eligible loans are likely to lead to increased issuance in the future.

1.9 INVESTOR PERSPECTIVE

By Ralf Burmeister, Deutsche Asset & Wealth Management

Another year in the covered bond market, another wild ride lies behind us. By the time last year's edition of the ECBC Covered Bond Fact Book had just been printed, the third buying Covered Bond Programme (CBPP3) from the European Central Bank (ECB) was announced, which came effectively out of the blue and hit market participants unexpectedly. The reaction, as demonstrated by the spread tightening after the September 2014 announcement, was in accordance with the situation. Having received this one particular lesson about the limitations of making forecast, we nevertheless believe that there are some trends in the covered bond market which are worth mentioning.

1) Transparency is still a valid and a "good" topic from the investor's point of view and there has been a decent progress in this area. But in our view, transparency is just one aspect amongst others when it comes to the definition or the actual structure of a covered bond. For most regulatory purposes, the minimum standards arising from the Undertakings for Collective Investment in Transferable Securities (UCITS) Directive and the Capital Requirements Regulation (CRR) are applied to determine whether a bond can be treated as a covered bond with all the regulatory beneficial treatment being attached to this status. Looking at the latest market developments, namely the shift away from hard-bullet structures towards soft-bullet, and even conditional pass-through structures, we understand the economic rationale, especially regarding the requirements from the rating agencies, behind this move. Furthermore, as we witness those changes take place in the area of special law-based covered bonds, it is fair to assume that these shifts are made with the consent of the regulator concerned. Accordingly, there seems to be no real preference for whatsoever structure (hard- or soft-bullet etc.) or willingness to discriminate amongst the various possibilities. Given the nature of any kind of pass-through structure, this implies that the argument of timely payment of covered bonds has lost some ground while the argument of protection of the principal has been benefitting. Looking at the rating impact of this shift away from hard-bullet bonds, it implies stable to slightly higher average ratings, as well as more buffer in case of issuer's downgrades. While better rating stability surely is beneficial to investors, the rising complexity of cash flows under non-hard-bullet covered bond structures needs to be reassessed by investors. It cannot be ruled out that despite full regulatory recognition, some new cash flow structures within covered bonds will not be fully embraced by investors due to individual guideline restrictions. These guidelines may be changed also over time, but that might also depend on the issues being discussed under point 2 below, namely some more clarity in the covered bond provisions as such.

2) The regulatory treatment and current recognition of covered bonds still is fine, but some work needs to be done as the whole banking regulation has changed. What has changed significantly in our view is the fact that the likelihood of an actual insolvency of a bank under the new supervisory system has declined. As it has always been a prerequisite of the covered bond to protect its investors from the insolvency of the issuer, it is fair to expect the covered bond wording to adapt to this new supervisory scheme. Accordingly, we need to clarify or emphasise what is being triggered or, maybe even more importantly, what is not going to get triggered once the issuer of a covered bond is undergoing the procedure of a bail-in or a split up ordered by the regulator in contrast to an insolvency procedure. The explicit exemption of covered bonds in the European bail-in regulation is an important milestone in that aspect but not the end of the road yet. This alignment of traditional covered bond wording ("In case of insolvency…") with new banking regulation is not necessarily to be seen as a major weakness being in an urgent need of getting fixed but, rather, the true and fair view that the rules, under which banks are operating today, have changed in recent years and the covered bond (wording) simply needs to adapt to that. There is a certain amount of best-guesses and fingers-crossed attitude amongst market participants when, for example,it comes to the treatment of covered bonds in a split-up scenario of the issuer. Though this common sense seems justified, as demonstrated

in the case we witnessed in Portugal, the traditional covered bond investors would nevertheless definitely prefer to have more clarity here. Explicit and transparent rules are clearly preferred over common sense. Besides, looking at the statements from various regulators regarding the topic "asset encumbrance", it seems also justified to start a discussion about the possible treatment of the level of overcollateralisation beyond legal minimum requirements in case of bail-in and/or split up, as well as the treatment of interest rate derivatives on the issuer's balance sheet which were used for asset-liability exercises in the cover pool management. In our view, this discussion should finally result in a couple of clarifications i.e. amendments of current legislations. We are not necessarily the advocates of a single European "one size fits all" covered bond legal framework. However, taking into account that some national legal frameworks do not yet allow for other structures than hard-bullet, as discussed in point 1 above, in combination with the general need to re-write covered bond legislation after the general banking regulation has changed gives us the impression that we are going to see a couple of legal amendments for covered bonds in the future.

3) "Hybrid" covered bonds or "innovative" covered bonds away from the common perception of what constitutes a covered bond (being backed by either mortgages or public sector debt, issued out of a bank, an on-balance instrument with a dual recourse, issued under special covered bond legislation) are being discussed from time to time but are falling short of truly showing up as a tradable product on capital markets. It is fair to assume that the low yield and low spread environment, despite the yield correction we had to witness in May 2015, is partly explaining the fact why innovations, already being discussed and being equipped with a pre-sale rating report, have not made their way into investor's portfolios (yet). The funding situation for banks in general is still very decent by the time of writing (May 2015), while loan demand across Europe is just starting to rise from a very low level. In view of this, the economic pressure to create new funding tools due to the fact that the existing ones are almost exhausted, is hardly present.

   Furthermore, within the complex upcoming banking regulation, it is fair to assume that, on average the funding mix of banks is rather shifting towards lower capital classes compared to covered bonds. Therefore, the incentive to create new products in vicinity to covered bonds is subdued. Besides, as other sources of bank funding currently are easy and cheap to use, it also makes sense in economic terms to keep the asset encumbrance rather low. So while the working group of the Covered Bond Investor Council (CBIC) dealing with new products on the market is still around, it has seen already busier periods.

   Having made the observation that there seems to be a period of little activity regarding new products, it is also fair to state that currently there is no rush of new countries jumping on the covered bond train. Both developments should not be seen as a sign of market deterioration in our view but, rather, a medium term effect. We have moved away from the height of the crisis into somehow calmer waters where banks have various funding options while loan demand is not overwhelmingly high. Thinking of a country such as Turkey, for example, which has been discussed for quite some time as a new market entrant, it is fair to state that the prospects for a decent covered bond issuance here are still intact but that the local issuers are in no way truly dependent on this particular instrument. We nevertheless would expect these two, as well as other candidates to finally make their way into the covered bond community in the medium term as it is no unusual observation that growth in the covered bond markets comes rather in waives than in quarterly steps. Albeit it is also true that given the current demand and supply pattern in the market, any new market entrant, either e.g. offering undisputed AAA or offering a decent spread, should be welcomed by investors.

4) Especially in Europe, covered bonds have become a tool within central bank's policy and market participants will have to deal with this fact. As it is a declared aim of the central banks to avoid credit risk wherever possible, we interpret this policy simply as a signal towards the generally low credit risk inherited in the covered bond product besides the room for improvement outlined above. Market wise, it will be interesting to see how central bank policy will change especially the investor landscape going forward, and how the market will react/ adapt to changes in the central bank policy.

So again, making forecasts for the next 12 months to come in our covered bond universe remains a very tough effort. Like in other fixed income markets, it seems obvious that we are not getting boring times. The safety of the covered bond instrument continues to be undisputed, which is an achievement in itself already. Needless to say, all parties involved should continue to work hard to keep it like this. Furthermore, despite the still low absolute yield levels, covered bonds have shown remarkably low levels of volatility which results in more stability for broader fixed income portfolios. So despite the latest changes in central behavior, we do not share the negative vision of a complete crowding out of private investors in the covered bond market, as certain features of the covered bond instrument will continue to be appealing beyond central banks as investors.

1.10 INVESTOR PERSPECTIVE OF THE COVERED BOND INVESTOR COUNCIL (CBIC)

By Patrik Karlsson, Covered Bond Investor Council

I. INTRODUCTION

The ICMA Covered Bond Investor Council ("CBIC") has continued its founding mission of encouraging greater transparency in covered bond products. The CBIC mission statement makes a specific reference to its intention to promote 'the high quality, simplicity and transparency of the product'. The CBIC members believe that the existing strong rules and limitations for eligible assets used in cover pools are a key reason why covered bonds are such a strong and well supported product. With this in mind, enhancing transparency and facilitating better comparison between covered bond programmes has been a natural priority work stream for the CBIC.

Furthermore, this has been a difficult year for covered bond investors. The European Central Banks's (ECB's) third Covered Bond Purchase Programme (CBPP3) has driven some investors out of parts of the covered bond market and changed the dynamics of the market. Estimates indicate that the ECB could end up owning 30% to 40% of the eligible euro benchmark covered bond market by the end of the CBPP3 in September 2016.

The CBIC has also taken note and reacted to the European Commission's consultation on creating a Capital Markets Union (CMU). The Commission's aim with the CMU initiative is to encourage growth in the European economy by unlocking alternative financing for companies, especially SMEs and for infrastructure projects.

The CMU Green Paper alludes to the desirability of a more integrated European covered bond market, which could contribute to cost-effective funding of banks and provide investors with a wider range of investment opportunities.

The Commission has also been considering the feasibility of developing a pan-European framework for covered bond issuance. They are also considering whether investors should be provided with more transparency in relation to the collateral underlying covered bonds – something the CBIC has been discussing for several years. One issue the Commission is looking at is the possibility of widening the use of a dual-recourse instrument for non-traditional assets, such as the SME loans. The CBIC is considering the Commission's ideas carefully and is contributing with investor views.

II. TRANSPARENCY DEVELOPMENTS

With regard to transparency, the main work the CBIC undertook in 2014 was a study on the national transparency templates and the active participation in amending the transparency requirements for covered bonds.

Therefore, the CBIC sponsored a report, written by Richard Kemmish, "Covered Bond Pool Transparency: The Next Stage for Investors" from August 2014. In addition the CBIC used its voice as a member of the Covered Bond Label Advisory Council to bring investor needs and thoughts into the discussions about how to structure improvements in the National Transparency Templates (NTT) for covered bonds. The NTTs are mandatory to obtain the ECBC Covered Bond Label and also function as a pattern for countries outside Europe.

The background to the Richard Kemmish report is based on the CBIC's data transparency initiative which was launched in March 2011 culminating in the publication of standardised disclosure templates and guiding principles (the 7□C) rules in May 2012. Although the CBIC template helped the issuer community understand investor wishes in terms of transparency, and was used by the issuer community as a benchmark to understand exactly what investors want to see, as was identified by Andreas Denger, Chair of the CBIC at the ICMA/Covered Bond Report conference in Frankfurt in May 2014, progress towards the disclosure defined in the template has been disappointing over the last two years.

In the meantime, significant developments have taken place in this field, the European Covered Bond Council (ECBC) Covered Bond Label Initiative, has facilitated the introduction of a series of improvements to the NTTs, which specify minimum pool disclosure on a country specific basis.

The ICMA report found specific shortfalls identified by investors which could be addressed to include the absence of one “go to” data repository for all issuers, the lack of documentary and/or structural disclosure of programmes and the lack of analytical tools for covered bond pools. The report also foreshadowed greater regulatory pressure for more disclosure.

The European Banking Authority (EBA) launched a report on 1 July 2014 on “EU Covered Bond Frameworks and Capital Treatment”, recommending greater transparency. The EBA recommended on investor disclosure that the legal/regulatory covered bond framework should require covered bonds issuers to disclose aggregate data on the credit risk, market risk and liquidity risk characteristics of the cover assets and the covered bonds of a given programme as well as other relevant information, including information concerning the counterparties involved in the programme and the levels of contractual and voluntary over-collateralisation.

EBA also recommended that the legal/regulatory covered bond framework should provide that the disclosure of the information should occur at least on a quarterly basis.

EBA furthermore believed that the disclosure criteria included in Article 129(7)(a) of the Capital Requirements Regulation (CRR) may leave excessive room for interpretation to both issuers and competent authorities.

Following the EBA report, the CBIC report and Mr Denger’s remarks at the 2014 ICMA/Covered Bond Report conference, the CBIC is pleased to see that due to the hard work in the ECBC (via its Transparency Task Force which has proposed a Harmonised Transparency Template that was approved by the Covered Bond Label Committee), most of the CBIC’s identified shortcomings have now been taken up in the Harmonised Transparency Template, which improves investor transparency significantly.

However, we would, in due course, like to see more progress on the disclosure of important structural details such as the source and amount of contractual over-collateralisation or the risks associated with cover pool swap counterparties.

III. ALTERNATIVE ASSET CLASSES

Turning to the European Commission’s plans for covered bonds, the CBIC will await the Commission’s consultation in the summer of 2015 and consider its proposals carefully. Some CBIC members have already been involved in the work led by the ECBC to consider how to extend the use of dual-recourse instruments to non-traditional assets, particularly SME loans. The Commission has shown that it is interested in exploring this further.

Without prejudicing the CBIC’s position with regard to the Commission’s forthcoming consultation, early impressions are that the Commission should not rush to develop new instruments that may be premature, at least in the short-term. With regard to the SME sector, investors would in many cases prefer to access this asset class through securitisation. In the longer term, we welcome a debate about how a new dual-recourse instrument, such as the ECBC’s helpful suggestion of a European Secured Note (ESN), could also fit into the SME financing market. The immediate focus for the Commission should be to revive the securitisation.

CHAPTER 2 - GENERIC SECTION

2.1 OVERVIEW OF COVERED BONDS

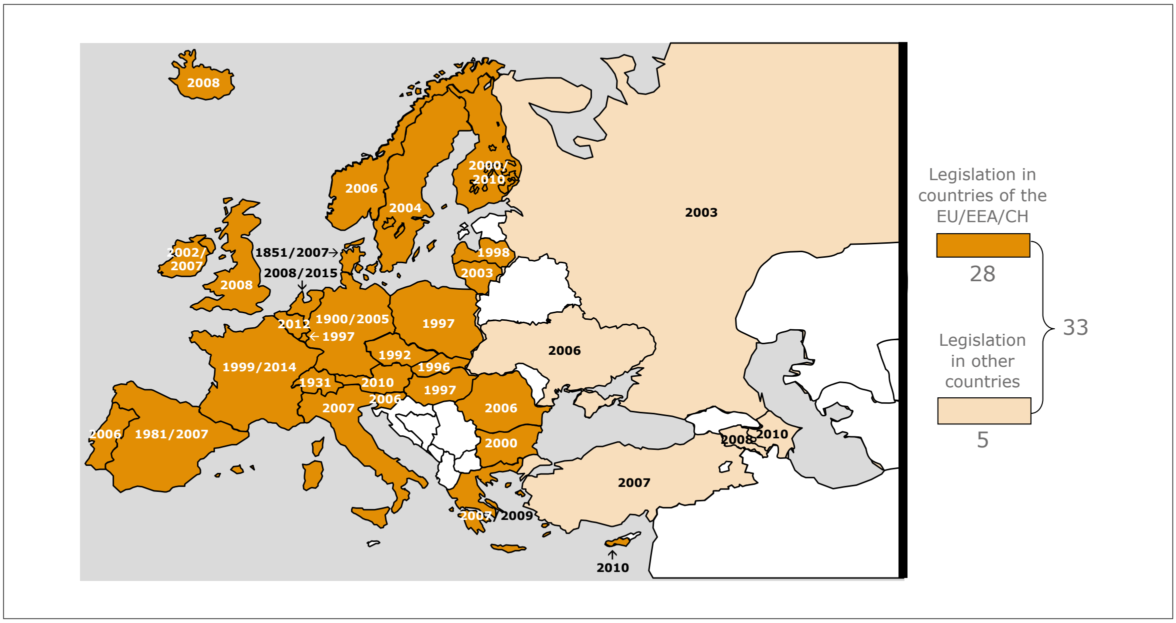
By Ralf Grossmann, Société Générale CIB & Chairman of the ECBC Technical Issues Working Group and Otmar Stöcker, Association of German Pfandbrief Banks

2.1.1 INTRODUCTION

Over the past 20 years, the covered bond market has developed into the most important segment of privately issued bonds on Europe's capital markets, with volume outstanding at the end of 2014 amounting to EUR 2.3 trillion[1]. Today, there are active covered bond markets (i.e. with issuance activity on a regular basis) in 28 different European countries (for more information, please refer to the covered bond statistics section in chapter 5)[2]. In addition, there are several European countries which have enacted or are in the process of updating or adopting covered bond legislation and are expected to launch active covered bond markets soon.

Outside the EEA, several countries (Australia, Canada, New Zealand, and South Korea) have already noteworthy active covered bond markets and numerous countries have enacted covered bond legislation (eg. Singapore, Turkey, Russia). Further countries where the creation of covered bond markets would make sense are OECD countries such as the US, Japan, Mexico, Chile, further countries such as Brazil, India or Thailand and countries with close ties to Europe such as Morocco or UAE, if they achieve high quality legislation for their covered bonds.

> Figure 1: Covered bond legislation in Europe (as of December 2014)


2008
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2007/2009
2010
Legislation in countries of the EU/EEA/CH
28
33
Legislation in other countries
5

Source: EMF-ECBC

Covered bonds have proved their resilience as funding instrument at various occasions during the financial and sovereign crisis. It is generally accepted that the covered bond market should play a pivotal role in bank wholesale funding as it provides lenders with a cost-efficient instrument of long-term funding for mortgage or public-sector loans and offers investors the best possible quality of credit exposure on credit institutions. The

[1] Source: EMF-ECBC, http://ecbc.hypo.org/Content/default.asp?PageID=519.

[2] For more information, please refer to the covered bond statistics section in Chapter 5 and the ECBC Covered Bond Comparative Database available at http://www.ecbc.eu/.

high importance of covered bonds for the financial system is also demonstrated by the privileges these instruments enjoy in various areas of EU financial market regulation. As well as the introduction of new covered bond legislations, there has been a continuous evolution of existing legislation, underlining the commitment of issuers, investors and regulators to further reinforce the quality of the asset class and take on board best practice.

2.1.2 HISTORY

The covered bond is a pan-European product par excellence. Its roots lay in ancient Greek mortgages and Italian and Dutch bonds. Decisive milestones in its development were laid in Prussia (1770), Denmark (1797), Poland (1825) and France (1852). The issuers ranged from public law "Landschaften" to private mortgage banks. The aim was first to finance agriculture and later concentrated more on housing and commercial real estate.

The creation and the expansion of covered bond systems in their different structures and features are a perfect example of a fruitful and effective exchange of ideas across all European borders. It is very impressive to see how the huge benefit of experience and exchange of international know-how contributed to the creation of covered bonds in Europe in the course of more than 240 years. In the 19th century, nearly every European country had a covered bond system. Their success influenced each other. Covered bonds also played an important role in stabilising financial systems at the end of the 19th century, a time of high bankruptcies of companies and banks.

Since the mid-20th century, the inter-bank market developed and, with it, a growing retail deposit base provided funding for mortgage loans. As a result, covered bonds in many European countries lost their outstanding importance. Some countries did not use their covered bond systems any more or even abolished them. This was the case in Western Europe and especially in Central and Eastern Europe, where private banking and capital market instruments did not comply with communist theories.

The situation changed in the last decade of the 20th century with the fall of Communism, the German reunification and the introduction of the Euro. In 1995, the first German Pfandbrief in benchmark format (Jumbo) was issued. The format was created in order to meet liquidity needs of investors and to provide increased funding for public sector lending. In the late 90s, Central and Eastern European countries reintroduced real estate finance techniques. Covered bonds were an important element in the process to fund the growing number of mortgage loans to establish private housing markets.

The introduction of the Euro and the subsequent decrease of interest rates led to a lending boom in Europe. Banks needed to look for new funding sources via high credit-quality liquid bonds to attract international capital investors. At the same time, investors could no longer diversify regarding currencies, but intensified their search for liquid products. Therefore, banks in Western countries revitalised their covered bond systems to create a competitive capital market instrument. Since then, the Jumbo market has expanded strongly. The financial crisis further strengthened the importance of covered bonds as the most resilient wholesale term-funding instrument for credit institutions.

2.1.3 THE BENEFITS OF COVERED BONDS[3]

The covered bond asset class plays a key role in guaranteeing the financial stability. Especially during the recent financial turmoil, covered bonds have been one of the only asset classes able to restore investor confidence and to ensure to European issuers access to debt capital markets. For over 200 years, covered bonds have proven to be an efficient debt instrument enabling banks to mobilise private sector means and capital towards long-term investment with a wide public benefit and, in particular, real estate loans and public sector debt.

[3] Main reference of that section is: ECBC's Position Paper on Asset Encumbrance and Response to the EBA Consultation Paper on Asset Encumbrance Reporting – 24 June 2013 available at http://ecbc.hypo.org/Content/default.asp?PageID=504.

Benefits from the issuer perspective

From an issuer's perspective, covered bonds provide a significant contribution to the enhancement of a banks' funding profile and the management of liquidity. Benefits provided by covered bonds include:

> Extending the maturity profile of the liabilities, allowing banks to better match their long-term asset portfolios;

> Providing stability to the funding mix, allowing asset liability management (ALM) teams to increase predictability in the maturity profiles;

> Enabling issuers to increase diversification in the investor base, both in terms of geography and investor type;

> Transforming less liquid mortgage loans into covered bonds which are eligible as collateral for central bank liquidity (including own use); and

> Serving the industry as one of the most reliable funding tools, even in times of turmoil.

Evidently, funding conditions of the banking sector are a key parameter for credit supply and, therefore, have important macro-economic repercussions. Conditions of mortgage credit supply impact the property market and, therefore, have important long-term effects on consumption and investment behaviour. Likewise, public sector covered bonds have undoubtedly reduced the funding costs of public sector borrowers. Moreover, homogenous funding instruments for banks lead to higher information efficiency increasing transparency as regards the pricing of loans (e.g. refer to the Danish mortgage bond system).

Benefits from the investor perspective

From an investor's perspective, the major strengths and regulatory advantages of covered bonds can be summarised as follows:

> Double recourse to issuer and cover pool and therefore higher recovery in case of liquidation;

> No risk of bailing-in;

> Higher rating and higher rating stability than unsecured debt;

> Lower-risk weighting for EEA Covered Bonds bought by EEA banks;

> Favourable treatment under Solvency II;

> Generally better liquidity through larger issue size;

> Favourable repo treatment at the European Central Bank (ECB) and other central banks;

> Eligible as liquid assets under upcoming Basel III rules.

The covered bond safety features (legal frameworks, high quality assets, special public supervision, etc.) and the favourable regulation around covered bonds (e.g. UCITS, CRD, Solvency II, lower ECB haircuts) reflecting those safety features, allows more institutional investors to buy covered bonds and encourages them to engage themselves on a larger scale than in others products.

Prevention against moral hazard risk

The fact that issuers of covered bonds keep the credit risk of cover bond collateral on their balance sheets ("skin-in-the-game") has been clearly identified, from a macro-prudential perspective, as an efficient and simple alternative to complex originate-to-distribute products and, therefore, as a key driver for a virtuous cycle in managing risks and ensuring financial stability. Generally, the combination of credit risk retention by the issuer and strict cover asset eligibility incentivise the issuer to maintain a high discipline in lending standards and underwriting criteria.

Resilient bank funding instrument

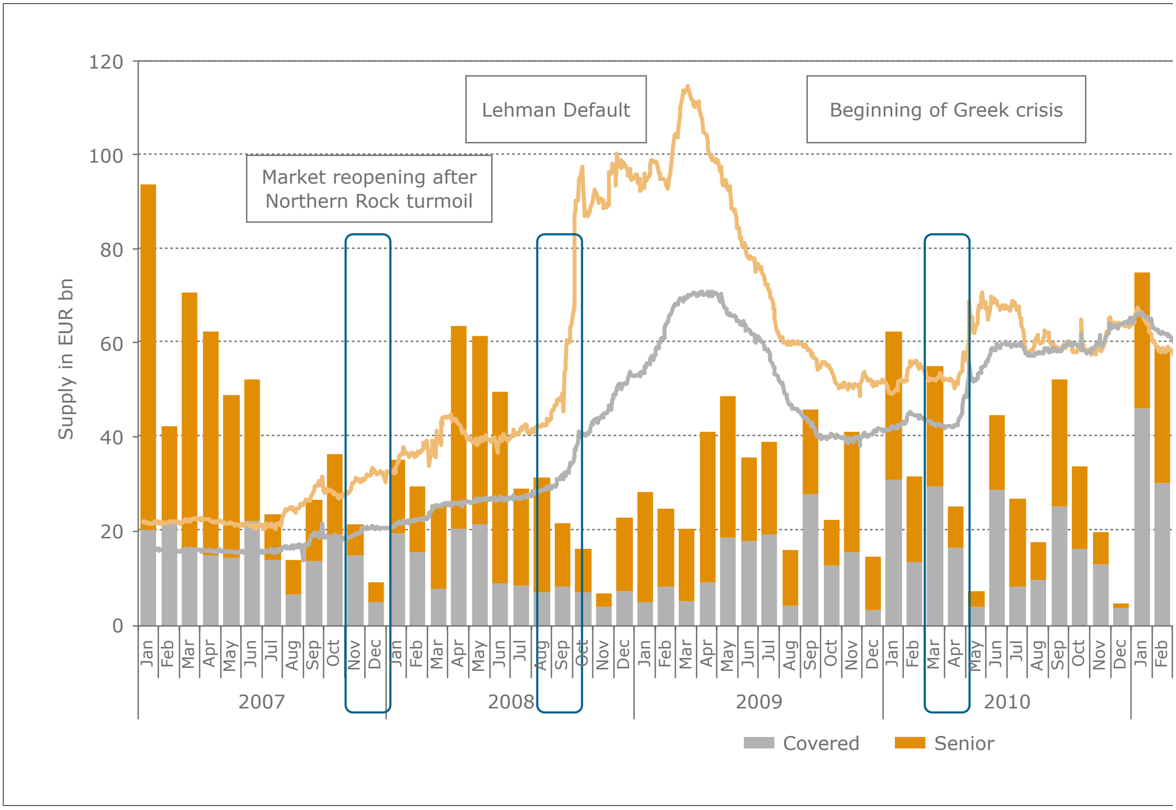
Covered bonds are the most reliable funding source as they make banks less susceptible to adverse market conditions. They often offer issuers better wholesale capital market access, lower transaction execution risk and decrease the reliance on senior unsecured funding and interbank markets. During the European sovereign crisis, it occurred that under certain conditions, over an extended period of time covered bond issuers had cheaper access to wholesale funding markets than their respective distressed sovereigns.

On the back of the severe market turmoil in 2008-2010, the ECB acknowledged the prominent role of covered bonds and stated in January 2011: "A smoothly functioning covered bond market is highly important in the context of financial stability."[4]

The chart below shows the primary market activity in EUR covered bond and senior unsecured markets combined with the spread developments in both markets. We have highlighted some periods of higher market volatility during the past eight years:

January/Feb 2008: On the back of the Northern Rock turmoil, starting in August 2007, market reopening in January 2008 was very much driven by covered bond issuance which brought confidence back and allowed senior unsecured markets to properly reopen again.

> FIGURE 2: SWAP-SPREAD AND PRIMARY MARKET EVOLUTION IN THE EUR COVERED BOND AND SENIOR UNSECURED MARKET



Source: Société Générale

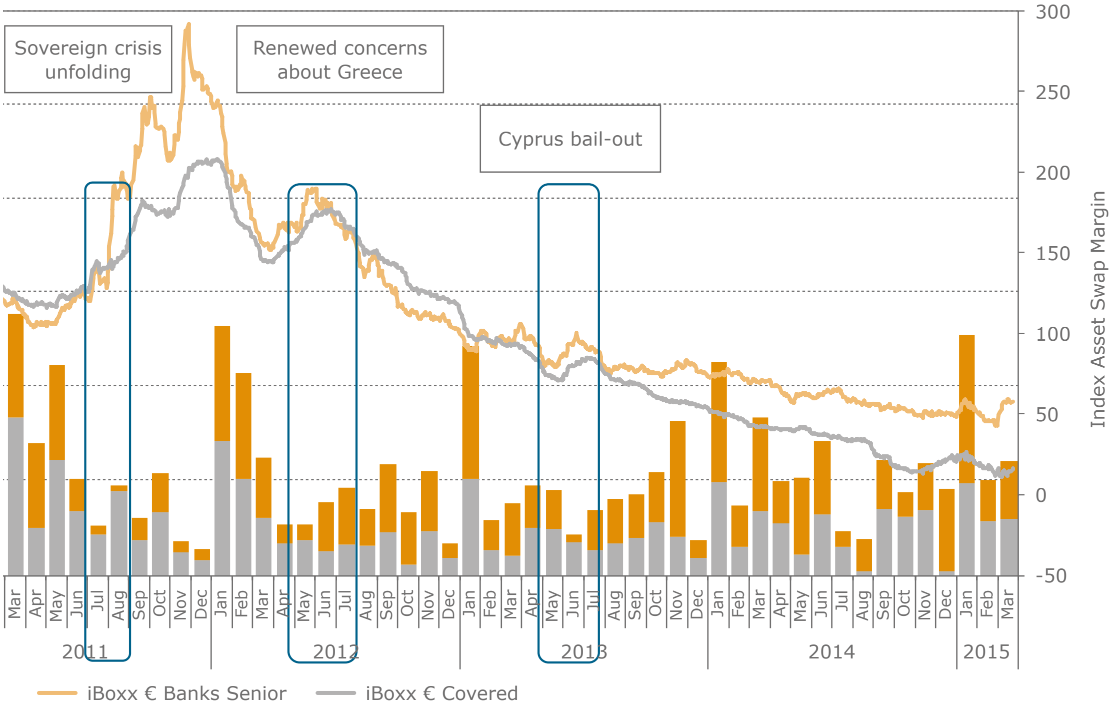
[4] See: The impact of the Eurosystem's covered bond purchase programme on the primary and secondary markets; Occasional Paper series, No 122 /January 2011, page 9.

October/November 2008: After the Lehman default on 15 Sept 2008, again covered bonds played a key role in re-opening wholesale funding markets for financials. Only taps of existing benchmarks in relatively small size and private placements were placed in the market.

April/May 2010: With the start of the Greece crisis, fresh volatility was introduced into the Financials primary market, which again put a damper on senior unsecured issuance. Covered bond primary market held much better also thanks to the support from the ECB CBPP1.

July/August 2011: As the sovereign crisis unfolded, senior unsecured primary market came to an almost complete stand-still, while covered bond primary market continued to see some decent activities over those summer months.

March/April 2012: The Cyprus bail-out marked another spike of volatility which negatively impacted primary market activities and again covered bond issuance took over the lead from senior unsecured which actually had been rather buoyant at the start of the year. The ECB CBPP2 provided some support throughout that period but already lost some importance with monthly purchase volumes at around EUR 1.5bn instead of the EUR 5bn we had seen during the CBPP1.



Covered bonds and asset encumbrance

As the crisis continued and covered bond issuance exceeded the issuance of senior unsecured bonds in the EUR market for the first time ever, asset encumbrance became a major topic in the financial stability debate. There are concerns that a high amount of bank assets, which are pledged to special creditors, and therefore would not be available in case of bank insolvency, would make banks more vulnerable in case of market turmoil and lead to further destabilisation of the system. However, when it comes to the importance of covered bonds for asset encumbrance, a more holistic approach needs to be adapted, taking into account the following points:

> The different covered bond models are characterised by the existence of risk cushions foreseen in their specific legal frameworks (strict supervision, eligibility criteria for high quality cover assets, etc.). Covered bond legislation acts, in practice, as an additional mitigant and issuance safeguard by requiring licenses for covered bond issuance and imposing strict collateral asset eligibility criteria.

> It is challenging to define what the ideal encumbrance equilibrium should be. Recent studies prove that there does not exist any evidence of correlation between the covered bond encumbrance of a bank and its senior unsecured spread levels.

> In particular, the existence of different business models requires a case by case interpretation of the level of asset encumbrance. For highly specialised issuers, for instance, the level of encumbrance – given a broad definition – is close to 100%. For those financial institutions which do not take any deposits, all senior investors are institutional investors who are well aware of their position in the priority ranking in case of insolvency. For such institutions, the high level of encumbrance is only a consequence of their business model and cannot be interpreted differently.

> Central bank and third party repo and credit support annexes of derivatives transactions are often more important and less transparent sources of asset encumbrance than covered bonds.

> Due to the restrictive cover pool eligibility criteria and the fact that cover pool monitor need to approve asset transfers, covered bond encumbrance tends to remain more stable and less sensitive to market conditions in times of turmoil than other forms of encumbrance arising from repo haircuts or derivative collateral.

> The covered bond market has experienced a smooth development over recent years with an average growth of 7.5% since 2007. Compared with the other forms of encumbrance (central bank repo transactions and derivative collateral), and considering the recent introduction of covered bond laws in a number of countries which did not have legislation on covered bonds in place, this remains a sustainable development. This growth has often been misinterpreted because, in parallel, the senior unsecured and securitisation issuance has been shrinking.

Covered bonds as a long-term funding tool for the real economy: the example of housing finance

Covered bonds are an effective tool to channel long-term financing for high quality assets at reasonable cost. They improve banks' ability to borrow and lend at long-term horizons and, hence, represent a stable source of funding for key banking function such as housing loans and public infrastructure. In this regard, we believe that covered bonds represent a key funding tool for the future European banking industry.

For instance, long-term financing is crucial for housing finance. Building or purchasing a home is the biggest investment for the majority of the European citizens, representing typically 4 to 5 times their annual income. In absence of pre-existing wealth, they would have to wait for 40 or 50 years if they had to rely solely on their individual savings.

Borrowing resources are therefore necessary to acquire a home and more generally to support the European economy. Given the size of the investment, their repayment must be spread out over a long period to be compatible with annual savings capacity and, hence, requires long-term funding tools for banks to avoid asset and liabilities mismatches.

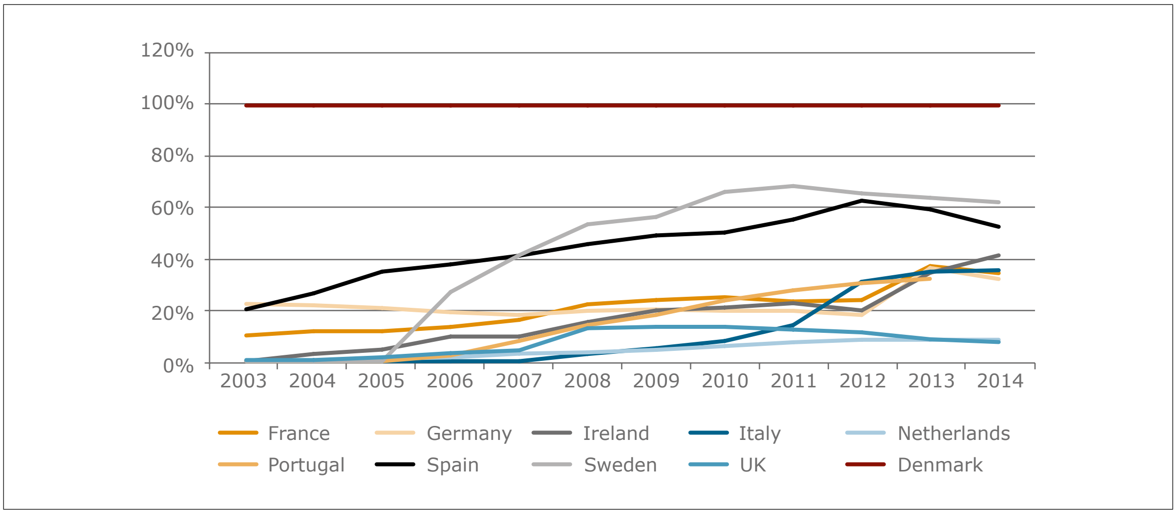
The efficient availability of mortgage finance is also based on the ready availability of financing at the longest tenors possible and the lowest price feasible. Without this, the mortgage market would be a function of market sentiment and the refinancing rates available to borrowers would be subject to much more price volatility, making planning for private households more challenging.

In this context and in particular in times of low risk appetite from investors, covered bonds with their key safety features such as strict legal and supervisory framework, asset segregation, a cover pool actively managed in order to maintain the quality of the collateral, play an essential role in ensuring the flow of capital in financing long-term growth and the real economy.

During the recent turmoil, the existence of a well-functioning covered bond market has allowed governments in Europe to constantly channel private sector funds to housing markets and maintain a relatively efficient lending activity without additional increase of the burden for taxpayers and public debts. This is the case for instance in the US, where 95% of the mortgage markets benefit from a governmental guarantee after the federal takeover of Fannie Mae and Freddie Mac.

The positive effects of covered bonds outlined in this section are clearly dependent on the extent of use of covered bonds within a particular country compared to the size of the domestic mortgage market and the alternative funding tools for banks (and their costs). The figure below confirms a comparatively high importance in most countries of the size of the covered bond market related to the volume of residential loans outstanding. Most of the countries have now reached stable relative size of the covered bond market after a phase of strong growth in 2007/2008 and more moderate growth subsequently.

> Figure 3: Mortgage backed covered bonds as % of residential mortgage loans

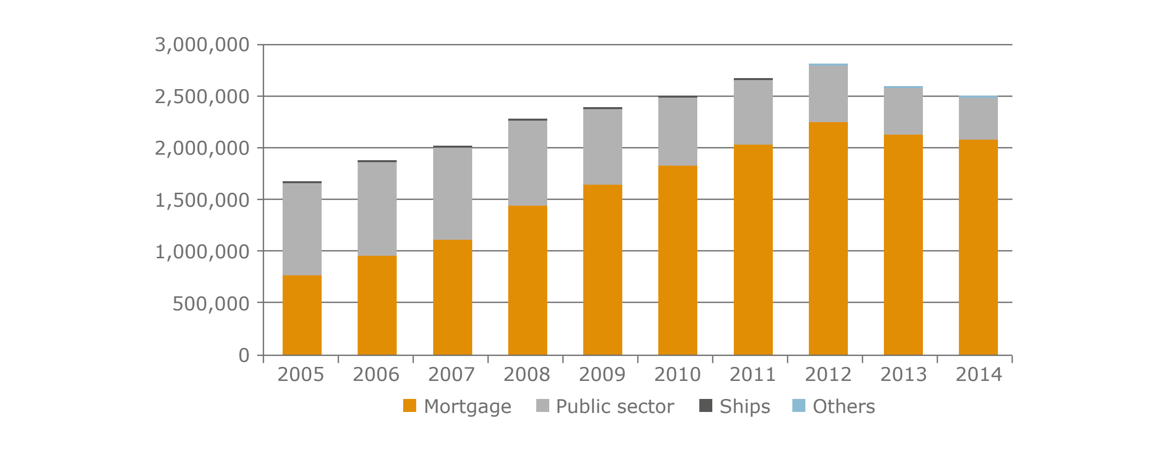


Source: EMF-ECBC

2.1.4 MORTGAGE – PUBLIC SECTOR – SHIP

The major categories of cover assets are mortgage loans, public sector loans and ship loans. The range of eligible cover assets is defined by a country's covered bond system. Covered bonds backed by mortgage loans exist in all countries with covered bond systems. Covered bonds to fund public sector lending (to national, regional and local authorities) are issued on a regular basis only in a limited number of European countries (Austria, France, Germany, Luxembourg, Norway, Spain and UK). Covered bonds backed by ship loans are rarer but can be found in Denmark and Germany. 2012 has seen first issuance of German Pfandbriefe backed by aircraft loans. In 2013, the first structured covered bond backed by SME loans was launched into the market by a German issuer. Italy and Spain have introduced special legislation permitting the issuance of covered bonds backed by other types of cover assets (SME, export finance, corporate bonds, receivables, etc.) but no issuance has occurred yet.

> Figure 4:Total outstanding covered bonds by underlying assets, 2005 to 2014



Source: EMF-ECBC – Covered bonds outstanding at the end of 2014.

2.1.5 ECBC COVERED BOND COMPARATIVE DATABASE

The ECBC website presents in an on-line database at www.ecbc.eu a comparative analysis, based on a questionnaire with the responses of 47 frameworks. The comparative overview is divided into 9 sections covering the essential features of the covered bond systems. In addition, links are provided to the covered bond section of all issuers' websites, as well as covered bond legislation in English. Here, we highlight some of the results of that comparative overview.

Structure of the issuer

In all of the countries that participated in our comparative analysis, the covered bond issuers are regulated institutions. A classification of covered bond systems by type of issuer results in the following four categories:

- Universal credit institutions;
- Universal credit institutions with a special license;
- Specialised credit institutions; and
- Special purpose entities.

Framework

In most European countries, the issuance of covered bonds is regulated by specific covered bond legislation. In some countries contractual arrangements complement existing general insolvency law protecting holders of secured debt. Frameworks set the rules for important features such as eligible assets, specific asset valuation rules, assets-liability-management guidelines and transparency requirements.

Identification of the legal framework for bankruptcy of the issuer of covered bonds is of particular importance. The legal basis in case of bankruptcy of the covered bond issuer is provided either by the general insolvency law or by a specific legal framework superseding the general insolvency law.

Cover assets

The eligible cover assets in existing European covered bond systems range from exposures to public sector entities, mortgage and housing loans, exposures to credit institutions to ship and aircraft loans. Some covered bond systems distinguish between regular cover assets and substitution assets, where the latter is often subject to quantitative restrictions.

The geographical scope for cover assets ranges from the domestic area only, over EEA countries up to OECD countries. A feature that gained importance is the existence of regular covered bond specific disclosure requirements to the public. Existing covered bond systems offer a broad range of different solutions. One can find disclosure requirements regulated by law, by contract or on a voluntary basis. In most covered bond countries, national data disclosure templates exist obliging the issuers (either by law or on a voluntary basis) to disclose standardised cover pool information.

Valuation of mortgage cover pool & LTV criteria

Most countries have legal provisions or at least generally accepted principles for property valuation. Those provisions are an essential element to guarantee a certain minimum credit quality of cover assets. In most cases, the property valuation is based on a mortgage lending or prudent market value. LTV limits for single assets are ranging for residential mortgage loans from 60% to 80%. In some countries, there are additional LTV limits on a portfolio basis.

Asset-liability guidelines

Asset-liability guidelines exist in most of the covered bond systems, but large differences in technical details and the degree of explicit regulation (e.g. by law, by supervisor, issuer's by-laws, contractual provisions or business policy) make a detailed comparison rather difficult. One often applied rule is the 'cover-principle', which requires that the outstanding covered bonds must *at all times* be secured by cover assets of at least equal nominal amount and yielding at least equal interest. Some covered bond systems have implicitly or even explicitly introduced additional net-present value asset/liability matching rules.

Similar, mandatory over-collateralisation (on a nominal or net-present value basis) plays an important role as a risk mitigation tool in some covered bond systems. Derivatives constitute an increasingly important class of risk mitigating instruments in covered bond asset-liability management. In numerous covered bond systems, derivatives are explicitly allowed in the cover pool for hedging purposes.

Cover pool monitor & banking supervision

Most covered bond systems have established an external, independent cover pool monitor who must have appropriate qualifications. Moreover, in most countries national banking supervisors (and in some cases, financial market regulators) exercise special supervision of covered bonds.

Segregation of assets & bankruptcy remoteness

European covered bond systems use different techniques to protect covered bondholders against claims from other creditors in case of insolvency of the issuer. Most systems establish by law or by contract the segregation of cover pools from the general insolvency estate. In other covered bond systems, the protection of covered bondholders is achieved through a preferential claim within the general insolvency estate.

Numerous covered bond systems have provisions that allow derivatives to become part of the cover pool with the purpose to hedge interest rate or currency mismatches. Derivative counterparties can rank *pari passu* or subordinated to covered bondholders. In covered bond systems, covered bondholders have recourse to the issuer's insolvency estate upon a covered bond default (*pari passu* with unsecured creditors or even superior to them).

Transposing the EU Bank Recovery and Resolution Directive (BRRD) into national law and adapting national law to the Single Resolution Mechanism (SRM) might trigger amendments of national covered bond legislations in order to keep cover pools and covered bonds ring fenced in resolution procedures.

Risk-weighting & compliance with European legislation

From our sample, most fulfil the criteria of Article 52(4) UCITS. In many countries, the covered bond legislation falls within the criteria of Article 129 of Regulation EU No 575/2013 (CRR). In some countries, the CRR criteria are not fulfilled or not applicable. Moreover, in most of the participating countries in our survey, covered bonds are eligible in repo transactions with the national central bank and special investment regulations for covered bonds are in place.

2.1.6 SUCCESS OF THE INSTRUMENT

The covered bond is one of the key components of European capital markets. The amount of outstanding mortgage covered bonds is equivalent to around 20% of outstanding residential mortgage loans in the EU. The volume outstanding at the end of 2014 amounted to 2.3 trillion EUR (covered bonds covered by mortgage loans, public-sector loans and ship loans), which represents a decrease of 7.5% year on year. The five largest issuing countries in 2014 were Denmark, Sweden, Germany, Italy and France respectively.

Covered bonds play an important role in the financial system and thereby contribute to the efficient allocation of capital and ultimately economic development and prosperity. The importance of covered bonds is also evidenced by the broad variety of different bond formats and currencies under which the product is issued and by the large investor base. Both subjects are addressed in the key themes section.

> Figure 5: Volume outstanding of covered bonds in selected countries end of 2014 in EUR million

	Public Sector	Mortgage	Ships	Others	Mixed Assets	TOTAL
Austria	19,279	22,450	-	-	-	41,729
Belgium	1,750	10,575	-	-	-	12,325
Cyprus	-	1,000	-	-	-	1,000
Czech Republic	-	11,106	-	-	-	11,106
Denmark	-	369,978	5,013	-	-	374,991
Finland	-	32,031	-	-	-	32,031
France	67,696	188,925	-	-	68,896	325,517
Germany	206,535	189,936	4,811	1,006	-	402,288
Greece	-	14,546	-	-	-	14,546
Hungary	-	3,272	-	-	-	3,272
Iceland	-	927	-	-	-	927
Ireland	20,258	18,473	-	-	-	38,731
Italy	8,700	122,464	-	-	-	131,164
Latvia	-	-	-	-	-	-
Luxembourg	16,002	-	-	-	-	16,002
The Netherlands	-	58,850	-	-	-	58,850
Norway	1,820	102,704	-	-	-	104,524
Poland	82	882	-	-	-	964
Portugal	400	33,711	-	-	-	34,111
Slovak Republic	-	3,939	-	-	-	3,939
Spain	25,495	282,568	-	-	-	308,063
Sweden	-	209,842	-	-	-	209,842
United Kingdom	6,152	130,797	-	-	-	136,949
Total EEA	374,169	1,808,975	9,824	1,006	68,896	2,262,870
Australia	-	61,326	-	-	-	61,326
Canada	-	64,836	-	-	-	64,836
New Zealand	-	9,464	-	-	-	9,464
Panama	-	247	-	-	-	247
South Korea	-	1,349	-	-	-	1,349
Switzerland	-	100,436	-	-	-	100,436
United States	-	4,000	-	-	-	4,000
Total Outside	-	241,657	-	-	-	241,657
Total	**374,169**	**2,050,633**	**9,824**	**1,006**	**68,896**	**2,504,527**

Source: EMF-ECBC

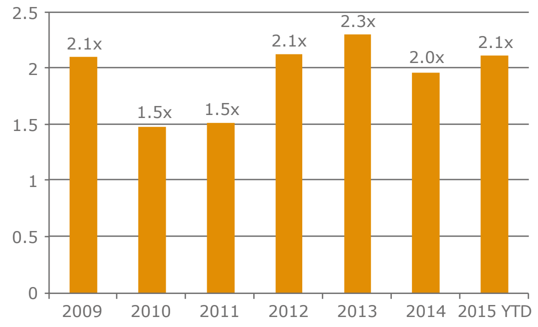
Notes: Please refer to section 5 for additional information on the ECBC statistics.

2.1.7 WHO BUYS COVERED BONDS

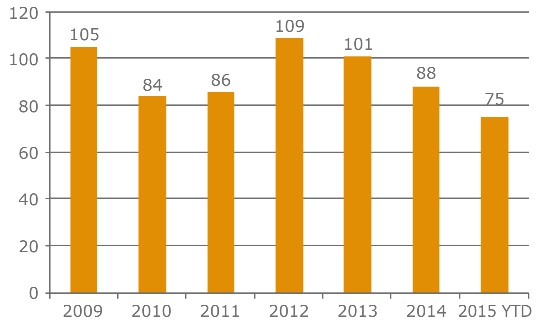
By Cristina Costa, Société Générale

Despite the start of the third covered bond purchase programme (CBPP3) initiated by the European Central Bank (ECB) in October 2014 and the significant spread tightening that has ensued, covered bonds continue to be well bid overall. In the primary market, the bid-to-cover ratio has remained pretty constant over recent years (averaging 2.1x in the period 2012 – 2015 YTD), although it is increasing recently for non-European ones (1.6x for Australian deals 2015 YTD vs 1.3x in 2014). In contrast, the average number of investors has declined in 2014 and YTD 2015 given the phenomenon of 1/an increase in the number of sub-Jumbo deals and 2/with the combination of low yields and low spreads, Eurosystem central banks have displaced some real money demand. In spite of Eurosystem central banks displacing part of the covered bond investor base, we expect sustained real money demand for covered bonds given lack of suitable alternatives and strong market technicals (declining EUR benchmark supply coupled with high volumes of redemptions).

> Figure 1: Global average oversubscription levels



> Figure 2: Average number of investors

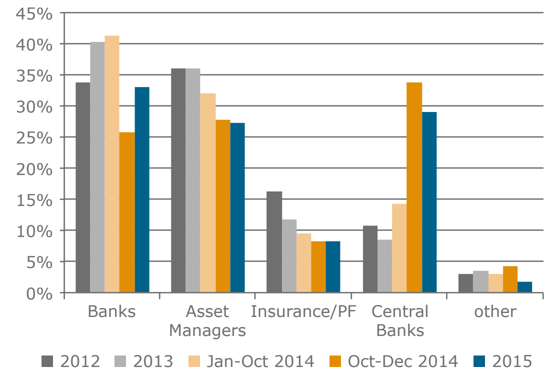


Source: SG Cross Asset Research/Rates

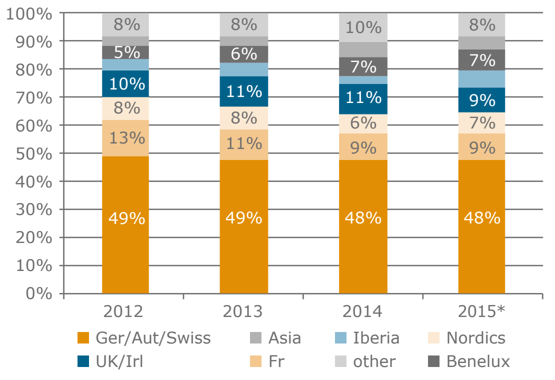
Why buy covered bonds? The rationale behind buying covered bonds has been driven by **favourable regulatory treatment** of covered bonds in Europe, with preferential risk-weighting, lower spread-risk charges under Solvency II, favourable haircut valuations for repo transactions with the ECB (vs senior bank debt and ABS), and inclusion as Level 1 and Level 2A assets under the EU's Liquidity Coverage Ratio (subject to fulfilling the requirements). In addition, covered bonds are the only non-bail-inable wholesale funding instrument. Although yielding much less today than they did 12-18 months ago, covered bonds continue to offer spread pick-up vs government bonds in most jurisdictions, except in European peripheral markets where they usually trade inside due to fundamental reasons. The relative value of peripheral covered bonds vs govies is driven by the fact there is protection through non-public-sector related cover pool (i.e. mortgages), issuers with diversified business model offer high resilience against domestic crisis, and covered bond spreads trend to be much less volatile trading in secondary markets than govies.

Who buys covered bonds? Bank treasuries remain the largest covered bond buyers mainly due to the LCR-bid, but also due to the uncertainty on the bail-inability of bank senior unsecured debt. Since mid-2014, bank treasuries have been investing further out the curve to avoid negative rates, and have added exposure to non-EEA paper and peripherals (on a selective basis). However, given the combination of low spreads and declining yields, bank treasuries have scaled down their covered bond investment. **Asset managers** were the second largest investors in 2014 and 2015YTD, but since October 2014, they have been reducing their covered bond holdings – both in terms of participation in primary deals, as well as in terms of their total outstanding – in favour of other asset classes with more tightening potential.

> Figure 3: Impact of CBPP3 strongly felt in primary deal statistics



> Figure 4: Allocation of euro benchmark covered bond issues by geography



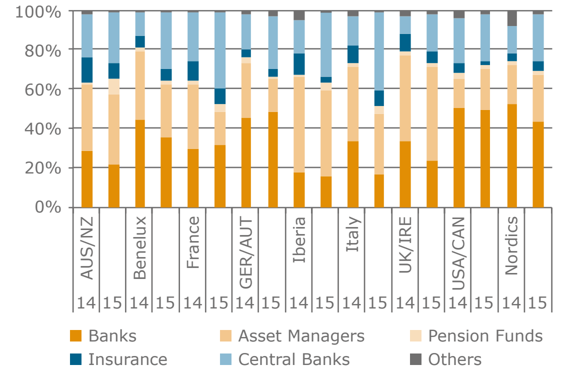
NB. 2015YTD = Jan-April;

Source: SG Cross Asset Research/Rates

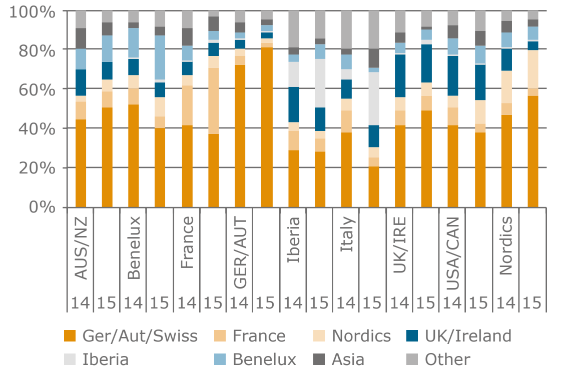
The biggest jump in investor demand has come from **central banks/official institutions**. These investors used to average 10-15% of order books, but with the ECB's CBPP3 programme, **central banks** are becoming one of the main covered bond investors. Although the ECB was initially putting in orders approximating 50% of a deal size, they have gradually decreased purchases to around 25% average currently. On the other hand, **insurance companies and pension funds have decreased their covered bond investments** in search of higher yielding alternatives (they are being forced to go longer duration and lower down the capital structure). Finally, given very low yields offered by covered bonds, **credit investors** have exited the market. Credit differentiation has faded away and investors are no longer paid for the additional bit of risk they take.

In terms of geography, while Germans/Austrians remain the largest investors in covered bonds, there is less of a home-bias as their respective markets become expensive and domestic investors search for higher yielding alternatives. Nevertheless, investors remain cautious in their investment choices: since the ECB's quantitative easing (QE) exit strategy is not yet known, they are concerned there could be a severe spread widening on covered bonds once the expanded asset purchase programme (EAPP) stops. The presence of Asian investors has expanded further, although they still have a preference for the best credits – whether in peripheral or core markets. US investors – mainly hedge funds – have largely exited the market.

> Figure 5: Allocation of euro benchmark covered bond issues by investor type



> Figure 6: Home bias still present in primary statistics



NB. 2015YTD = Jan-April;

Source: SG Cross Asset Research/Rates

Where do we go from here? CBPP3 means spreads are gone, yield is gone, but some investors (e.g. credit investors) have exited the segment and the granularity in books has diminished overall. The covered bond market has rarely been less attractive – on absolute yield levels, covered bonds have never been richer and in ASW terms, only a few segments from the periphery have not yet reached pre-crisis levels (although they are very close). The persistent central bank bid is set to squeeze liquidity in the market further and displace an ever increasing number of private investors. In addition, the growing number of sub-benchmark-sized deals means there is an imbalance in supply/demand, and many investors complain about poor allocation in primary deals. If the situation continues for much longer, the fear is that resources allocated to the product will decrease in the future, and there is no guarantee that these resources will be re-allocated back.

Despite Eurosystem central banks displacing part of the covered bond investor base, we expect real money demand for covered bonds to be sustained given lack of suitable alternatives and strong market technicals (declining EUR benchmark supply coupled with high volumes of redemptions). Most investors we speak to remain neutral covered bonds, trying to add some exposure through primary. So far, investors have managed to survive the squeeze by buying the outperforming and higher yielding periphery, by going longer out the curve, by switching into covered bonds not eligible for CBPP3 and by turning to other currencies (USD, GBP, DKK...).

Why will investors remain invested in the product? Many large investors are holding bonds in hold-to-maturity portfolios where you cannot sell them. And many existing bond holdings are swapped so you have to unwind the swap to actually get the bond. When we speak to bank treasurers, they are reluctant to sell their liquid portfolios, because selling means having to replace assets in an extremely tight spread environment. Furthermore, client discussions (in particular with insurance companies) suggest that none of them are interested in selling their holdings at the current levels. Monetising MtM gains would imply paying a high level of taxes. And reinvesting in fixed-income product at today’s rich levels is therefore unattractive. One thing is for sure, having displaced so much private demand – which will be slow to come back – the ECB will need to give careful consideration to its exit strategy by ensuring there is enough time to wean investors off QE.

2.2 REGULATORY ISSUES

2.2.1 COVERED BONDS AND EU BANKING REGULATIONS

By Frank Will, HSBC and Chairman of the ECBC EU Legislation Working Group

Over the last few years, covered bonds were able to ensure a preferential regulatory treatment compared to many other asset classes reflecting the strengths and low risks of the product. The most important regulatory rules include the Bank Recovery and Resolution Directive (BRRD) which exempts covered bonds from bail-in, the Liquidity Coverage Ratio (LCR) which categorises covered bonds as highly liquid assets, the Capital Requirement Regulation (CRR) which assigned low risk weights to covered bonds and, last but not least, Solvency II which grants low spread risk factors to covered bonds. The last two play a very important role for the banking sector and the insurance industry, respectively.

In addition, there are currently several other initiatives by European and global regulators under way which could have wider implications for the covered bond product and the issuers of covered bonds. Below we provide an overview of the planned or currently discussed major regulatory amendments which could affect the covered bonds.

I. TOWARDS "BASEL IV"

The Basel Committee on Banking Supervision (BCBS) plans to further develop the requirements of Basel III. The discussed amendments go into the direction of a fundamentally overhauled standard – already dubbed by some as "Basel IV". The far-reaching changes include, among others, a revision of the standardised approach, the potential introduction of a capital floor and an overhaul of the internal risk models.

Revision of the standardised approach

Back in December 2014, the BCBS released a consultation document on the revisions to the standardised approach for credit risk. The BCBS paper evaluates the options of replacing references to external ratings, as used in the current standardised approach, with a limited number of risk drivers that provide a meaningful differentiation for risk. Concretely, the Basel Committee suggests:

(1) reducing the reliance on external credit ratings;

(2) enhancing the granularity and risk sensitivity;

(3) updating the risk weight calibrations;

(4) improving the comparability with the internal ratings-based (IRB) approach;

(5) providing better clarity on the application of the standards.

Regarding residential and commercial real estate lending, the Basel Committee suggests that:

> **Residential real estate loans** would no longer receive a 35% risk weight. Instead, risk weights would be based on two commonly used loan underwriting ratios: the amount of the loan relative to the value of the real estate securing the loan (i.e. the loan-to-value ratio) and the borrower's indebtedness (i.e. a debt-service coverage ratio).

> Regarding **commercial real estate loans**, two options are currently under consideration: (i) treating the exposures as unsecured with national discretion for a preferential risk weight under certain conditions or (ii) determining the risk weight based on the loan-to-value ratio.

Introduction of a new capital floor

The BCBS has also published a consultation paper on the introduction of a capital floor. This capital floor would be based on standardised, non-internally modelled approaches and would replace the existing transitional capital floor based on the Basel I framework. The regulators believe that such a floor would mitigate model risk and measurement error stemming from internally-modelled approaches. It should also enhance the comparability of capital outcomes across banks, and ensure that the level of capital across the banking system does not fall below a certain level.

Other BCBS issues

In addition, the BCBS will conduct a strategic review of the IRB models. Part of the review will focus on the way the IRB models are being used and could result in overall re-calibration of the framework to make the internal risk weights between banks more comparable. Furthermore, the regulators will review the preferential treatment of sovereign exposures.

II. EUROPEAN SECURED NOTES (ESN)

Back in February 2015, the European Commission published a Green Paper on "Building a Capital Markets Union". The aim of the Capital Markets Union (CMU) is to improve long-term financing of the European economy by overcoming the adverse effects of financial fragmentation in Europe and to achieve a better allocation of financial resources across Europe. The Green Paper focuses, in particular, on the SME sector in Europe and argues for a much broader approach on long-term financing going well beyond traditional funding provided by banks. In the paper, the European Commission also outlined its plans to discuss a range of policy options to achieve greater integration in the covered bond markets.

In response to the European Commission initiative, the European Covered Bond Council (ECBC) suggested in May 2015 the introduction of a new dual recourse financial instrument in the European Union to address a funding segment located between the traditional covered bond and high-quality securitisation: the so-called European Secured Notes (ESN). The ESN would benefit from the market best practices of both traditional covered bonds (for funding purposes) and securitisation (for funding and risk-sharing purposes). Such an instrument could be backed by SME loans or other types of assets, such as infrastructure loans and could contribute to the CMU growth objective. The ECBC proposed two implementation options for ESNs: (i) an on-balance sheet dual recourse instrument with a dynamic pool for long-term financing purposes; or (ii) an off-balance sheet dual recourse instrument with static pool that could also offer risk transfer and risk sharing (plus capital relief) as a response to deleveraging needs. The ECBC suggests using various models and options for the national implementation of ESNs, as this would allow regulators, supervisory authorities and market participants to identify the best way of introducing such an instrument in different market and legislative environments. This would also help to facilitate a rapid legislative implementation of qualitative standards with a bottom-up approach, and to develop homogenous and comparable characteristics.

Crucial for the success of such a tool would be a positive regulatory recognition of this financial instrument, regardless of the respective structure. These regulatory incentives should ideally comprise of eligibility for LCR and central bank repurchase transaction, lower risk weight under the CRR and Solvency II, CRA III Regulation, as well as being exempted from bail-in under the BRRD.

The success of the ESNs in terms of new issue volumes and achievable funding levels will to a large extent depend on the level of preferential treatment granted by the European regulatory authorities to this new asset class. Moreover, it will be important to ensure a clear distinction by market participants between the ESNs and the traditional covered bonds as the risk profiles of the underlying assets in terms of probability of default (PD) and loss given default (LGD) differ significantly.

III. NET STABLE FUNDING RATIO (NSFR)

The Basel III framework and the Capital Requirement Regulation (CRR) introduced two liquidity standards: the Liquidity Coverage Requirement (LCR) and the Net Stable Funding Ratio (NSFR). While the LCR rules will be phased-in in Europe from October 2015, the NSFR is planned to come into force by 2018, if deemed necessary.

The CRR states that "by 31 December 2016, the Commission shall, if appropriate, […] and taking full account of the diversity of the banking sector in the Union, submit a legislative proposal to the European Parliament and the Council on how to ensure that institutions use stable sources of funding." The Basel Committee went already a step further and issued the final standard for the Net Stable Funding Ratio (NSFR) back in October 2014.

The following analysis is based on the Basel paper and highlights the issues for the covered bond market that could arise from one-to-one implementation of the Basel standard into European law.

The NSFR is calculated as the ratio of Available Stable Funding (ASF) to Required Stable Funding (RSF), which has to be greater than 100%. ASF and RSF are calculated on the liabilities and assets, respectively, weighed by specific factors. These factors depend among others on the remaining maturity, the type of assets and the encumbrance status.

$$\text{NSFR} = \frac{\text{Available Stable Funding (ASF)}}{\text{Required Stable Funding (RSF)}} \geq 100\%$$

The unmodified implementation of the Basel NSFR requirements into EU law would result in several issues for the covered bond market. The largest problems for the covered bond market are the following:

Encumbrance problem

In general, residential mortgages with a residual maturity of 1 year or more, that qualify for a risk weight of 35% or lower under the Basel II standardised approach, have a RSF of 65%. However, if mortgage loans form part of the cover pool, then they are regarded as encumbered which means that the required stable funding ratio jumps from 65% to 100%. This means that from a simple RSF perspective senior unsecured debt would be a more attractive funding channel than covered bonds.

Treatment of over-collateralisation

The different RSF treatment of encumbered and unencumbered assets becomes even more pronounced and could have unintended consequences in case of (voluntary) over-collateralisation. If the required funding for cover assets representing the over-collateralisation is higher than that for the same assets outside the cover pool, issuers will have an incentive to keep a low over-collateralisation level from a RSF perspective.

Covered bonds with maturities under 1 year

As highlighted above, covered bonds with a remaining maturity of 1 year and more will provide available stable funding of 100%. Encumbered residential mortgages in the cover pool will have a matching RSF factor of 100%. However, if the remaining maturity of the covered bonds drops below 1 year or below 6 months, then the ASF will drop to 50% and 0%, respectively (see Figure 1). At the same time, mortgage loans encumbered for a period of less than 1 year will be treated as unencumbered and will have a RSF of 65% (assuming residual loan maturities of more than 1 year). This means that covered bonds will have a 15 percentage point shortfall between ASF and RSF for remaining maturities of 6 months to 1 year and even a 65 percentage point shortfall for the last 6 months before their maturity date. This seems inconsistent given the matched funding character of covered bonds.

Figure 1: Divergent treatment of covered bonds and cover pool assets

Covered bonds		Residential mortgages in the cover pool*
Remaining maturity	**Available Stable Funding**	**Required Stable Funding**
>= 1 year	100%	100%
6 months below 1 year	50%	65%
below 6 months	0%	65%

Source: HSBC, BCBS

* Residual maturity is above 1 year, risk weight of 35% or less under the standardised approach

There are also some question marks regarding the treatment of swap agreements on covered bonds. Moreover, the ECBC argues that the RSF should be consistent with the LCR rules. Hence, covered bonds that qualify for Level 1 HQLA should have a RSF of 5%, while Level 2A and Level 2B covered bonds should have a RSF of 15% and 50%, respectively.

In summary, there are several issues with the NSFR that would be problematic for the mortgage market and the covered bond product and would unduly hit the covered bond industry if introduced in Europe in its current form. However, given the importance covered bonds play in financing the mortgage market in Europe (which is for instance very different from the way mortgages are financed in the US) and given the favourable treatment of covered bonds under the LCR, the final NSFR rules should take into account the warranted industry concerns if the European Commission decides to implement the NSFR. The NSFR would likely be applied from the beginning of 2018, which seems to be a long way away. However, it seems likely that investors will demand from banks to fulfil the NSFR requirements much ahead of the actual introduction date, reducing the timeframe for making any amendments to the NSFR rules.

IV. LEVERAGE RATIO

The BCBS rules will require banks to maintain a leverage ratio of 3% from 2018 onwards. The final calibration is expected to be completed by the end of 2015. The European Commission should follow with a leverage ratio proposal before the end of 2016 which could also come into force by 2018. There have been some efforts by the banking industry to achieve an exemption for specialist lenders, as a one-size-fits-all approach would unduly punish banks focusing on assets with low risk weights. The CRR explicitly states that during the review of the impact of a leverage ratio on different business models, particular attention should be paid to business models which are considered to entail low risk, such as mortgage lending and specialised lending with regional governments, local authorities or public sector entities. However, it seems that regulators are reluctant to grant an exemption for certain asset classes as this would open a Pandora's box and could trigger a wider discussion about the treatment of other low-risk asset categories. One other option would be to exempt smaller institutions from the leverage ratio – although such a size-based rule would not work too well with the idea of a 'level playing field' in Europe.

Besides this, there are even discussions at the BCBS level about a potential increase of the leverage ratio beyond the current 3% limit driven primarily by the United States representatives. In the US, the forthcoming requirements for large banks are already significantly higher. From the beginning of 2018, the US regulators will demand a minimum leverage ratio of 3% for US banks using the advanced internal rating models. Globally systemically important banks (G-SIBs) will be required to have higher leverage ratios of 5%. Insured deposit-taking institutions of G-SIBs must maintain even a leverage ratio of at least 6% to be considered as 'well capitalised'.

In Canada, the Office of the Superintendent of Financial Institutions (OSFI) requires bank to maintain a leverage ratio of 3% or higher. However, the OSFI can set higher requirements on an institution-by-institution basis. This so-called 'authorised leverage ratio' is considered supervisory information and is not permitted to be disclosed.

An increase in the leverage ratio beyond the currently envisaged 3% would hurt the willingness and ability of particularly European banks to lend and would over-proportionally hit European issuers with large mortgage portfolios. In stark contrast to the US where large parts of the mortgage financing is indirectly provided by Government Sponsored Enterprises (GSEs), such as Fannie Mae or Freddie Mac, real estate lending in Europe is still mainly funded by the banking sector.

Liquidity Coverage Ratio (LCR)

On 10 October 2014, the European Commission published its delegated act on the liquidity coverage ratio (LCR) which will require banks to hold a certain amount of liquid assets to cover their net cash outflows over 30 days. The LCR ratio will be phased-in from October 2015 to the beginning 2018 to allow credit institutions sufficient time to build up their liquidity buffers, whilst preventing a disruption of the flow of credit to the real economy during the transitional period.

The phase-in schedule is defined as follows:

> 60% of the final requirements from 1 October 2015;

> 70% from 1 January 2016;

> 80% from 1 January 2017, and

> 100% from 1 January 2018.

The full implementation of LCR by 2018 is one year earlier than demanded by the Basel standard. Furthermore, at the national level, banks can be required by their regulators to hold LCR levels up to 100% before the LCR is fully introduced in 2018. In a stress scenario, a bank might end up in a situation in which it has to use its liquid assets. Under such circumstances, its LCR levels could (temporarily) fall below 100%. However, the bank would be required to immediately notify the competent authorities and submit a plan for the timely restoration of the LCR to above 100%.

As the liquidity buffer is to reach a considerable level of a bank's balance sheet (10% or more of the total assets of an average EU bank according to EBA estimates), the implementation of the LCR is likely to sustain the demand for eligible bonds. Currently, most European banks already over-fulfil the LCR requirements, as highlighted by several quantitative impact studies. According to issuer feedback, many bank treasuries have focused on cash and government bonds to reach the required LCR levels. We expect that over the coming years, banks will aim at optimising their liquid asset portfolios under both liquidity and return aspects as it becomes more and more difficult for bank treasurers to produce a positive profit contribution in the current low yield environment and negative ECB deposit rates.

Quick overview of the various LCR classifications

Level 1 HQLAs (High Quality Liquid Assets) include cash, deposits at the central bank, all types of bonds issued or guaranteed by the EU Member States' central government, covered bonds that meet certain conditions, as well as certain agency and supranational issues. Regarding the classification of EU sovereign bonds, no distinction was made between member states as that could have led to a fragmentation of the internal market and potential contagion risk.

Level 2A assets include regional governments, local authorities or public sector entities (PSEs) with a risk weight of 20% and covered bonds with a credit quality step 2 rating (at least A-) and non-EU covered bonds rated at credit quality step 1 (at least AA-). Corporate bonds with at least credit quality step 1, a minimum issue size of EUR250m and maximum maturity of 10 years at the time of issuance are also classified as Level 2A.

Level 2B incorporates high quality securitisations for RMBS, auto, SME and consumer loans and high quality covered bonds that do not meet the rating threshold of Level 1 and 2A. Shares meeting certain conditions and corporate bonds with at least credit quality step 3 (at least BBB-), a minimum issue size of EUR250m and maximum maturity of 10 years at the time of issuance are accepted as Level 2B.

Classification of covered bonds

Level 1 HQLAs (High Quality Liquid Assets) include covered bonds that meet certain conditions, including being issued by an issuer in the European Economic Area (EEA), having a credit quality step 1 (at least AA-), a minimum size of EUR500m equivalent and a minimum over-collateralisation of 2%. The rating threshold will be based on a second-best rating approach in line with capital requirement rules (CRR) rather than on the ECB's best rating rule. Whilst other Level 1 assets are not subject to either liquidity buffer limits or to a haircut to their market value, Level 1 covered bonds will be subject to a 70% cap in the liquidity buffer and a 7% haircut.

Level 2A HQLAs include:

> EEA covered bonds with a credit quality step 2 rating (A- or better), a minimum size of EUR250m equivalent and minimum over-collateralisation of 7%;

> EAA covered bonds with a credit quality step 1 rating (AA- or better), an issue size below the EUR500m threshold (but still meeting the minimum size of EUR250m equivalent) need a lower minimum over-collateralisation of 2%;

> Non-EEA covered bonds rated at credit quality step 1 (AA- or better) with a minimum over-collateralisation of 7%. There is no minimum size requirement. However, bonds with a size of EUR500m equivalent or more need only a minimum over-collateralisation of 2%.

Level 2A covered bonds can be used for up to a maximum of 40% in the liquidity buffer and are subject to a 15% haircut.

Level 2B HQLAs comprise high quality securitisations for RMBS, auto, SME and consumer loans. These can be used for up to a maximum of 15% in the liquidity buffer and are subject to a minimum haircut varying between 25% and 50%. Other high quality EAA covered bonds that do not meet the rating threshold of Level 1 and 2A also fall under this category. However, the haircut for these covered bonds is relative high at 30% and the cap is set at 15%.

Furthermore, in order to qualify, EEA covered bonds must be UCITS or CRR compliant. Non-EAA covered bonds must have a national covered bond law. In addition, all covered bonds must fulfill the transparency requirements of Article 129 (7) CRR.

Basel's LCR rules are less favourable

The BCBS LCR rules are less favourable than the EU regulation. Under the Basel rules, covered bonds are defined as bonds issued and owned by a bank or mortgage institution that are subject by law to special public supervision designed to protect bond holders. Issue proceeds must be invested in conformity with the law in assets which, during the entire period until the maturity of the bonds, are capable of covering the preferential claims of the covered bond investors.

On top of that, covered bonds have to (i) be rated AA- (second-highest rating), (ii) have a proven track record as a reliable source of liquidity reflected by a maximum price drop of 10% over 30-day period of stress, (iii) be traded in large, deep and active repo/cash markets with a low level of concentration, and (iv) cannot be issued by the submitting bank itself. Covered bonds meeting these criteria qualify as Level 2A assets rather than Level 1 as under the EU rules and are therefore subject to a haircut of 15% and a cap of 40%.

Capital Requirement Regulation (CRR)

The CRR came into force on 1 January 2014. It assigns relatively low risk weights to covered bonds meeting certain criteria. In order to be eligible for the preferential risk weights, covered bonds have to fulfil the requirements of Article 52(4) of the EU Directive 2009/65 (Directive on Undertakings of Collective Investment in Transferable Securities; UCITS). On top of that, they have to meet the additional eligibility criteria for cover assets of Article 129 CRR.

Article 52(4) UCITS requires that:

> - covered bonds are issued by a EU credit institution;
> - they are subject by law to special public supervision designed to protect bondholders;
> - the issue proceeds are only invested in eligible assets in accordance with the law;
> - the bonds are backed by eligible assets during the entire period until their maturity, and
> - in the event of issuer default, investors have a preferential claim on the cover assets covering principal and accrued interest.

Article 129 CRR goes beyond the UCITS requirements and demands that the bonds are only collateralised by the following assets (please note that the rating requirements refer to the credit quality step definition by the EU and generally focus on the second-best rating in case of split ratings):

(a) exposures to or guaranteed by central governments, Eurosystem central banks, public sector entities, regional governments or local authorities in the EU;

(b) exposures to or guaranteed by third-country central governments and central banks, multilateral development banks, international organisations rated at least AA-, and exposures to or guaranteed by third-country public sector entities, regional governments and local authorities that are rated at least AA- and are risk weighted as exposures to credit institutions, central governments or central banks; lower rated exposures with a minimum rating of A- cannot exceed 20% of the nominal amount of outstanding covered bonds;

(c) exposures to credit institutions with a minimum rating of AA-. The total exposure shall not exceed 15% of the nominal amount of outstanding covered bonds. The supervisory authorities can allow, after consulting EBA, a lower minimum rating of A- for up to 10 % of the total outstanding covered bonds, provided that the application of the higher rating requirement would potentially result in concentration problems. Exposures to EU credit institutions with a maturity not exceeding 100 days shall not be comprised by the AA- requirement but those institutions shall have a minimum rating of A-;

(d) loans secured by residential property up to an LTV of 80 %; or by senior RMBS tranches issued by securitisation entities governed by the laws of a member state. The supervisory authority has to ensure that at least 90% of the underlying assets are composed of residential mortgages that have a maximum LTV of 80%. The senior tranches have to have a minimum rating of AA- and do not exceed 10% of the nominal amount of the outstanding issue;

(e) French residential loans with an LTV of up to 80% and a loan-to-income ratio not exceeding 33% which are fully guaranteed by an eligible protection provider rated at least A-. There shall be no mortgage liens on the residential property when the loan is granted, and for the loans granted from 1 January 2014 the borrower shall be contractually committed not to grant such liens without the consent of the credit institution that granted the loan. The protection provider shall be a supervised financial institution subject to prudential requirements comparable to those applied to credit institutions. Both the credit institution and the protection provider shall carry out a creditworthiness assessment of the borrower;

(f) loans secured by commercial immovable property up to an LTV of 60% or by senior CMBS tranches issued by securitisation entities governed by the laws of a member state. The supervisory authority has to ensure that at least 90% of the underlying assets are composed of commercial mortgages that have a maximum LTV of 60%. The senior tranches have to have a minimum rating of AA- and do not exceed

10% of the nominal amount of the outstanding issue. Commercial mortgage with an LTV of up to 70% can be included if the over-collateralisation is at least 10%;

(g) ship mortgage loans with an LTV of up to 60%.

Transparency requirement

Article 129(7) CRR defines certain transparency requirement for covered bonds. It states that covered bonds are eligible for preferential treatment if the covered bond investor can demonstrate to its regulatory authorities that portfolio information are provided by the issuer at least semi-annually:

- Value of the cover pool and outstanding covered bonds
- Geographical distribution
- Type of cover assets
- Loan size
- Interest rate and currency risks
- Maturity profile of cover assets and covered bonds
- Percentage of loans more than 90 days past due

Standardised approach

Covered bonds fulfilling the aforementioned criteria are eligible for a preferential risk weight under the CRR. In contrast to previous regulation, the risk weights under the standardised approach are based on the covered bond ratings rather than the issuer ratings. Figure 2 shows that covered bonds rated at least AA-/Aa3 qualify for a 10% risk weighting which increases to 20% for bonds being rated from A+/A1 to BBB-/Baa3. For non-investment grade covered bonds rated at least B-/B3 the risk weight is 50%.

Figure 2: Risk weightings of rated covered bonds under the standardised approach

Credit quality step (covered bonds)	1	2	3	4	5	6
Covered bond rating	**AAA to AA-**	**A+ to A-**	**BBB+ to BBB-**	**BB+ to BB-**	**B+ to B-**	**below B-**
Covered bond risk weight	10%	20%	20%	50%	50%	100%

Source: EU, HSBC (Mapping of credit quality steps to rating is based on the second-highest eligible rating in case of split-ratings)

In case of unrated covered bonds, the risk weighting is linked to the issuer rating. However, the risk weights of the covered bonds are significantly lower than those for senior unsecured exposures (see Figure 3 below).

Figure 3: Risk weightings of unrated covered bonds under the standardised approach

Credit quality step (Issuer)	1	2	3	4	5	6
Issuer rating	**AAA to AA-**	**A+ to A-**	**BBB+ to BBB-**	**BB+ to BB-**	**B+ to B-**	**below B-**
Issuer risk weight	20%	50%	50%	100%	100%	150%
Covered bond risk weight	10%	20%	20%	50%	50%	100%

Source: EU, HSBC (Mapping of credit quality steps to rating is based on the second-highest eligible rating in case of split-ratings)

The Internal Ratings-Based Approach (IRBA)

Under the CRR, banks can opt for using approaches based on internal ratings. Under these internal ratings-based approaches (IRBA), risk weight calculations are based upon a complex formula. This formula uses as inputs the probability of default within a one-year horizon (PD), the loss given default (LGD), the exposure at default (EAD) and the effective time to maturity (M) of the individual securities.

Under the Foundation IRB (FIRB), financial institutions have to estimate PD based upon their internal risk-scoring models; PD refers to the exposure to the corporate/institution, not the bond itself, and is floored at 0.03%. M should be set to 0.5 years in case of repo transactions and to 2.5 years when assessing all other exposures; M can upon approval from the regulator also be fixed at actual maturity but not shorter than one year and not longer than five. Covered bonds meeting the aforementioned eligibility criteria may be assigned an LGD value of 11.25%.

If a financial institution opts for the Advanced IRB (AIRB) instead, it will have to assess all risk components on an individual basis. Under both approaches, irrespective of the country or region within which the bank holding the covered bond is incorporated, the PD to be employed will always only reflect the PD of the issuer. The PD of the collateral pool of the CB is not relevant. In no case can the PD be less than 0.03%. Institutions that opt for the advanced approach may use an LGD lower than 11.25%. Those banks will also use the actual M, though the value will be capped for values below 1 and values above 5.

Figure 4 below shows the risk weighting for different PD assumptions and maturities. In all cases, the LGD is set at 11.25%. In case of the FIRB, the maturity is set at M= 2.5 years – this is highlighted in grey in the figure. The PD is based on S&P default statistics (for the years 1981-2013), floored at 0.03%. A covered bond issued by a bank with an internal issuer rating equivalent to single-A (which translates into a 1-year PD of 0.07%) and a maturity of 5 years would have a risk weight of 6.37% under the FIRB and of 10.62% under the AIRB.

Figure 4: Internal risk weights of covered bonds under the FIRB and the AIRB

Issuer rating equivalent	PD used	Maturity in years					
		1	2	2.5	3	4	5
Aaa/AAA	0.03%	2.01%	3.22%	3.83%	4.43%	5.65%	6.86%
Aa/AA	0.03%	2.01%	3.22%	3.83%	4.43%	5.65%	6.86%
A/A	0.07%	3.82%	5.52%	6.37%	7.22%	8.92%	10.62%
Baa/BBB	0.21%	8.21%	10.70%	11.94%	13.19%	15.67%	18.16%
Ba/BB	0.82%	17.76%	21.06%	22.72%	24.37%	27.68%	30.99%
B/B	3.01%	29.14%	32.43%	34.07%	35.71%	38.99%	42.27%
below B	10.34%	47.22%	50.27%	51.80%	53.33%	56.38%	59.44%

Source: EU, S&P, HSBC (FIRB: M= 2.5 years; PD is based on S&P figures and is floored at 0.03%)

With regard to the relevant insurance regulation at European level, please refer to the article following next.

2.2.2 INSURANCE REGULATION – SOLVENCY II

By Florian Eichert, Crédit Agricole CIB and Chairman of the ECBC Statistics & Data Working Group

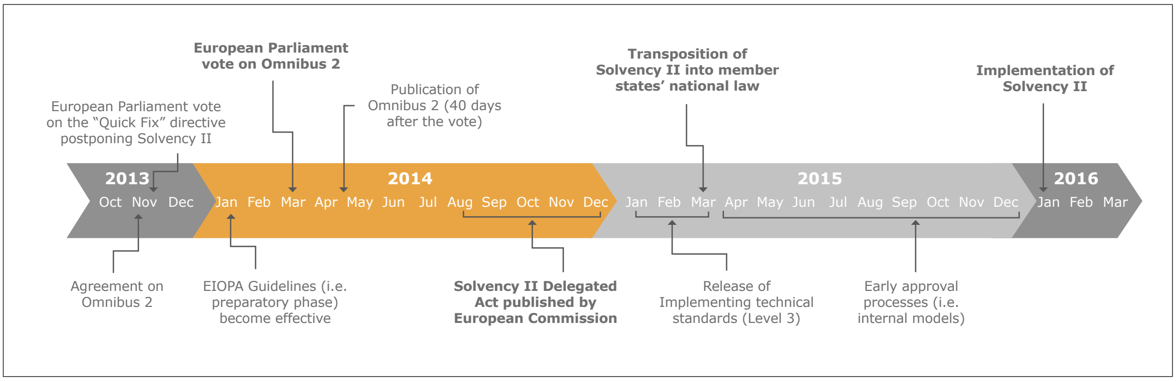
The Solvency II Directive (2009/138/EC) is what the Capital Requirements Directive (CRD) IV is for the banking world – a regulatory regime that introduces risk based capital charges. It is also an attempt to harmonise the EU insurance landscape.

While the Solvency II Directive was adopted by the European Parliament and the Council of the European Union in November 2009, the actual implementation, however, has by now been delayed quite a few times. In the past, the implementation date was a moving target that was regularly pushed down the road whenever the previous target became unrealistic.

In the meantime, amendments to the original Solvency II Directive had become necessary to be in line with EU's implementing measures according to the Lisbon Treaty of 2009 and EU's new supervisory structure by introducing the European Insurance and Occupational Pensions Authority (EIOPA). These amendments are implemented through the so-called Omnibus II Directive.

The agreement on Omnibus II was passed by the European Parliament on 11 March 2014 after a text had been agreed between the European Commission, Parliament and Council on 13 November 2013. Solvency II will now come into effect on 1 January 2016.

Figure 1: Timeline of implementation


European Parliament vote on Omnibus 2
Publication of Omnibus 2 (40 days after the vote)
European Parliament vote on the "Quick Fix" directive postponing Solvency II
Transposition of Solvency II into member states' national law
Implementation of Solvency II
2013
Oct Nov Dec
2014
Jan Feb Mar Apr May Jun Jul Aug Sep Oct Nov Dec
2015
Jan Feb Mar Apr May Jun Jul Aug Sep Oct Nov Dec
2016
Jan Feb Mar
Agreement on Omnibus 2
EIOPA Guidelines (i.e. preparatory phase) become effective
Solvency II Delegated Act published by European Commission
Release of Implementing technical standards (Level 3)
Early approval processes (i.e. internal models)

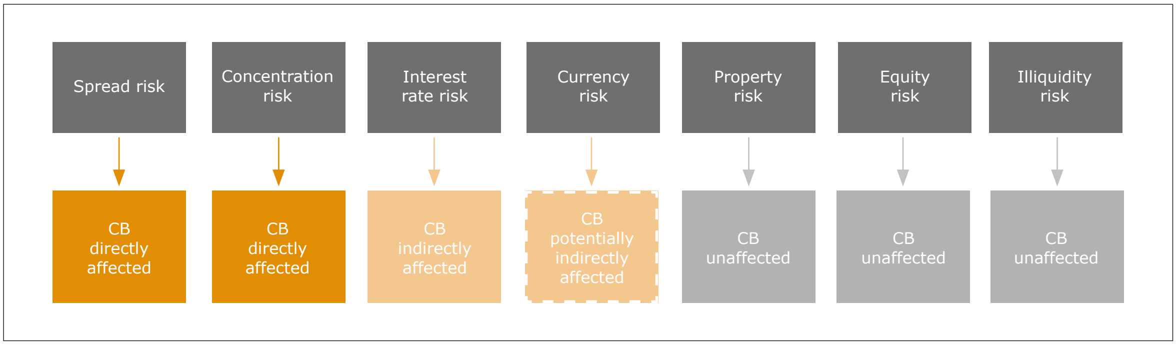
Source: European Commission, Crédit Agricole CIB

OVERVIEW OF SOLVENCY II – WHERE ARE COVERED BONDS IMPACTED?

Solvency II is a highly complex framework which addresses a vast number of different sources of risks that all interact with each other to come up with a final solvency capital requirement (SCR). Risks range from market risk to underwriting risk, longevity risk or default risk on loan exposures.

Covered bonds are mainly affected by the market risk section and specifically mentioned in the spread risk and concentration risk modules.Figure 2: Market risk modules in Solvency II and their relevance for covered bonds.

> FIGURE 2: MARKET RISK MODULES IN SOLVENCY II AND THEIR RELEVANCE FOR COVERED BONDS



Source: EIOPA, Crédit Agricole CIB

SPREAD RISK MODULE

The spread risk module is the biggest single investment specific driver of capital charges under Solvency II. Interest rate risk is an even bigger driver of capital charges overall but other than spread risk is driven by the overall asset and liability structure of an insurance company and not by the individual asset purchased.

EIOPA describes spread risks as the "results from the sensitivity of the value of assets, liabilities and financial instruments to changes in the level or in the volatility of credit spreads over the risk-free interest rate term structure." In other words, we are talking about the spread vulnerability in volatile scenarios. Spread risk applies to virtually all fixed income instruments apart from EU member states' sovereign debt as well as non-member states' sovereign debt that is rated AA- and better.

Since insurance companies are longer term investors than banks, capital charges for investments are also significantly higher than they are for banks. In addition to this, they are not only driven by credit risk, as is the case for the standardised approach in banking regulation, but are also determined by a combination of rating and duration. The weaker the rating and the longer the investment, the higher the capital charge. The spread risk module capital charges are expressed as a charge per year of duration. Initially, Solvency II had planned for a strictly linear relationship between duration and capital. This, however, was changed with the increase per extra year of duration beyond 5Y having been reduced and a further flattening of the increase after 10Y. After all, the long end is exactly where insurance companies are active and regulators did not want to dis-incentivise them through onerous capital charges.

Covered bonds do receive preferential treatment under the spread risk module if they comply with the following criteria:

> They have a credit quality step 0 or 1 which means a minimum rating of AA-;

> They meet the requirements defined in Article 52(4) of the UCITS Directive 2009/65/EC,

For covered bonds that fulfil the UCITS Directive and are rated AAA, a spread risk factor of 0.7% applies per year of duration up to 5Y while AA- to AA+ rated ones have a factor of 0.9%. Covered bonds that do not meet these requirements are treated as senior unsecured exposure. Capital charges are 0.2% higher per duration year.

When looking at the numbers it is also important to mention that the percentages do not relate to 8% of the invested notional as is the case in the banking world but to the actual invested notional. A 10% risk-weight on covered bonds essentially means a 0.8% capital charge for a bank. Talking about 0.7% capital charge in Solvency II for an equally rated 1Y covered bond also means 0.7% capital relative to the invested notional. The longer the duration of the bond is, the higher the Solvency charge becomes in both absolute terms as well as relative to bank capital charges. While the AAA covered bond with a 1Y maturity is treated slightly better under Solvency II, (0.7% vs. 0.8%), the relationship reverses from year 2 onwards. For an AAA rated 10Y covered bond, insurance companies have to hold 6% of the invested notional in capital, which is 7.5 times as much as banks.

> Figure 3: Formulas for the Solvency II capital charge calculations for covered bonds and other asset classes

Credit quality	Up to 5 years	5 to 10 years	10 to 15 years	15 to 20 years	20 years +
AAA covered	0.7% * D	3.5% + 0.5% * (D -5)	6% + 0.5% * (D -10)	8.5% + 0.5% * (D -15)	11% + 0.5% * (D -20)
AA + to AA- covered	0.9% * D	4.5% + 0.5% * (D -5)	7% + 0.5% * (D -10)	9.5% + 0.5% * (D -15)	12% + 0.5% * (D -20)
A+ to A- covered	1.4% * D	7% + 0.7% * (D -5)	10.5% + 0.5% * (D -10)	13% + 0.5% * (D -15)	15.5% + 0.5% * (D -20)
BBB+ to BBB- covered	2.5% * D	12.5% + 1.5% * (D -5)	20% + 1% * (D -10)	25% + 1% * (D -15)	30% + 0.5% * (D -20)
BB+ to BB- covered	4.5% * D	22.5% + 2.5% * (D -5)	35% + 1.8% * (D -10)	44% + 0.5% * (D -15)	46.6% + 0.5% * (D -20)
EU member states' direct central government exposure / guaranteed but EU member central governments (irrespective of rating)	0.0%	0.0%	0.0%	0.0%	0.0%
AAA to AA- sovereign third country	0.0%	0.0%	0.0%	0.0%	0.0%
A+ to A- sovereign	1.1% * D	5.5% + 0.6% * (D -5)	8.4% + 0.5% * (D -10)	10.9% + 0.5% * (D -15)	13.4% + 0.5% * (D -20)
BBB+ to BBB- sovereign	1.4% * D	7% + 0.7% * (D -5)	10.5% + 0.5% * (D -10)	13% + 0.5% * (D -15)	15.5% + 0.5% * (D -20)
BB+ to BB- sovereign	2.5% * D	12.5% + 1.5% * (D -5)	20% + 1% * (D -10)	25% + 1% * (D -15)	30% + 0.5% * (D -20)
AAA corporate	0.9% * D	4.5% + 0.5% * (D -5)	7.2% + 0.5% * (D -10)	9.7% + 0.5% * (D -15)	12.2% + 0.5% * (D -20)
AA+ to AA- corporate	1.1% * D	5.5% + 0.6% * (D -5)	8.4% + 0.5% * (D -10)	10.9% + 0.5% * (D -15)	13.4% + 0.5% * (D -20)
A+ to A- corporate	1.4% * D	7% + 0.7% * (D -5)	10.5% + 0.5% * (D -10)	13% + 0.5% * (D -15)	15.5% + 0.5% * (D -20)
BBB+ to BBB- corporate	2.5% * D	12.5% + 1.5% * (D -5)	20% + 1% * (D -10)	25% + 1% * (D -15)	30% + 0.5% * (D -20)
BB+ to BB- corporate	4.5% * D	22.5% + 2.5% * (D -5)	35% + 1.8% * (D -10)	44% + 0.5% * (D -15)	46.6% + 0.5% * (D -20)
AAA ABS	2.1% * D for type 1; 12.5% *D for type 2; 33% * D for re-securitisations				
AA + to AA- ABS	3.0% * D for type 1; 13.4% *D for type 2; 40% * D for re-securitisations				
A+ to A- ABS	3.0% * D for type 1; 16.6% *D for type 2; 51% * D for re-securitisations				
BBB+ to BBB- ABS	3.0% * D for type 1; 19.7% *D for type 2; 91% * D for re-securitisations				
BB+ to BB- ABS	82.0% *D for type 2; 100% * D for re-securitisations				

Source: EIOPA, Crédit Agricole CIB

> Figure 4: Solvency II capital charges for covered bonds and other asset classes

Credit quality	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15
AAA covered	0.7%	1.4%	2.1%	2.8%	3.5%	4.0%	4.5%	5.0%	5.5%	6.0%	6.5%	7.0%	7.5%	8.0%	8.5%
AA + to AA- covered	0.9%	1.8%	2.7%	3.6%	4.5%	5.0%	5.5%	6.0%	6.5%	7.0%	7.5%	8.0%	8.5%	9.0%	9.5%
A+ to A- covered	1.4%	2.8%	4.2%	5.6%	7.0%	7.7%	8.4%	9.1%	9.8%	10.5%	11.0%	11.5%	12.0%	12.5%	13.0%
BBB+ to BBB- covered	2.5%	5.0%	7.5%	10.0%	12.5%	14.0%	15.5%	17.0%	18.5%	20.0%	21.0%	22.0%	23.0%	24.0%	25.0%
BB+ to BB- covered	4.5%	9.0%	13.5%	18.0%	22.5%	25.0%	27.5%	30.0%	32.5%	35.0%	36.8%	38.6%	40.4%	42.2%	44.0%
AAA to AA- EU sovereign	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
A+ to A- EU sovereign	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
BBB+ to BBB- EU sovereign	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
BB+ to BB- EU sovereign	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
AAA to AA- sovereign	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
A+ to A- sovereign	1.1%	2.2%	3.3%	4.4%	5.5%	6.1%	6.7%	7.3%	7.9%	8.5%	8.9%	9.4%	9.9%	10.4%	10.9%
BBB+ to BBB- sovereign	1.4%	2.8%	4.2%	5.6%	7.0%	7.7%	8.4%	9.1%	9.8%	10.5%	11.0%	11.5%	12.0%	12.5%	13.0%
BB+ to BB- sovereign	2.5%	5.0%	7.5%	10.0%	12.5%	14.0%	15.5%	17.0%	18.5%	20.0%	20.5%	22.0%	23.0%	24.0%	25.0%
AAA corporate	0.9%	1.8%	2.7%	3.6%	4.5%	5.0%	5.5%	6.0%	6.5%	7.0%	7.5%	8.0%	8.5%	9.0%	9.5%
AA+ to AA- corporate	1.1%	2.2%	3.3%	4.4%	5.5%	6.1%	6.7%	7.3%	7.9%	8.5%	8.9%	9.4%	9.9%	10.4%	10.9%
A+ to A- corporate	1.4%	2.8%	4.2%	5.6%	7.0%	7.7%	8.4%	9.1%	9.8%	10.5%	11.0%	11.5%	12.0%	12.5%	13.0%
BBB+ to BBB- corporate	2.5%	5.0%	7.5%	10.0%	12.5%	14.0%	15.5%	17.0%	18.5%	20.0%	21.0%	22.0%	23.0%	24.0%	25.0%
BB+ to BB- corporate	4.5%	9.0%	13.5%	18.0%	22.5%	25.0%	27.5%	30.0%	32.5%	35.0%	36.8%	38.6%	40.4%	42.2%	44.0%
AAA ABS (type1)	2.1%	4.2%	6.3%	8.4%	10.5%	12.6%	14.7%	16.8%	18.9%	21.0%	23.1%	25.2%	27.3%	29.4%	31.5%
AA + to AA- ABS (type1)	3.0%	6.0%	9.0%	12.0%	15.0%	18.0%	21.0%	24.0%	27.0%	30.0%	33.0%	36.0%	39.0%	42.0%	45.0%
A+ to A- ABS (type1)	3.0%	6.0%	9.0%	12.0%	15.0%	18.0%	21.0%	24.0%	27.0%	30.0%	33.0%	36.0%	39.0%	42.0%	45.0%
BBB+ to BBB- ABS (type1)	3.0%	6.0%	9.0%	12.0%	15.0%	18.0%	21.0%	24.0%	27.0%	30.0%	33.0%	36.0%	39.0%	42.0%	45.0%

Source: EIOPA, Crédit Agricole CIB

The capital charge differences between AAA and AA rated covered bonds are noticeable but not huge (1% difference for 10Y). The moment covered bonds drop into single A space and thus lose their preferential treatment, differences start to become very pronounced though (4.5% difference for 10Y) and with BBB (14.0% difference for 10Y) and BB covered bonds (29% difference for 10Y) they become massive.

When looking across asset classes, it becomes apparent that Solvency II favours sovereign debt over corporate and covered bonds. Nonetheless, differences between corporates and equally rated covered bonds are not massive (1.2% difference for 10Y AAA).

There have been improvements in how especially lower rated type 1 securitisation deals are treated. While keeping the 2.1% spread risk charge for AAA rated ABS, the figure was set at a flat 3% per year of duration for those ABS rated AA to BBB. The latter had still had a spread risk charge of 8.5% per year of duration before the adjustment. Despite this even the highest quality securitisation have around three times the capital requirement of AAA covered bonds in 5Y (10.5% vs. 3.5%) and three and a half times in 10Y (21% vs. 6%). For lower rated ABS, the difference to equally rated covered bonds in for example 10Y is 23% (30% vs. 7%).

Trying to translate the different capital requirements into spread numbers that one product has to yield in excess of another is not a straightforward exercise. After all, spread risk is merely one factor and there are many others driving the final SCR. It also depends on the return on equity an insurance investor needs to generate. Nonetheless, we have tried to estimate the additional yield required to cover the extra capital from this risk module.

> We have calculated the average capital charge for a buy and hold investor over the whole life of the investment;

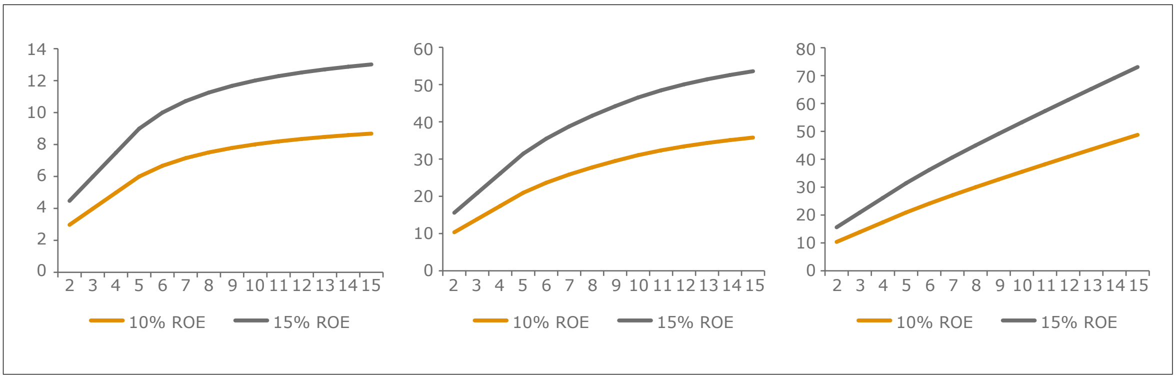
> We have then used two different ROEs, 10% and 15%, to calculate the extra return needed to fulfil this return requirement.

> FIGURES 5: SPREAD IN BP NEEDED TO COMPENSATE FOR ADDITIONAL CAPITAL BETWEEN...

...AA RATED COVERED AND AAA RATED COVERED BOND BY MATURITY

...A RATED COVERED / CORPORATE AND AAA RATED COVERED BOND BY MATURITY

...AAA RATED COVERED AND AAA RATED SOVEREIGN BOND BY MATURITY



Source: EIOPA, Crédit Agricole CIB

The charts above show the required spread pickup for a range of product pairs.

CONCENTRATION RISK MODULE

The concentration risk is defined by the EIOPA as "the risk regarding the accumulation of exposures with the same counterparty" which means that large exposures on a single issuer should be limited. Other concentration types dealing with geographical area, industry sector or the like are not considered though.

Similar to the spread risk module, covered bonds receive a preferential treatment here in the sense that the concentration threshold is much higher at 15% than it would be for equally rated corporate debt for which exposure to a single counterparty is limited to 3%.

> FIGURE 6: CONCENTRATION RISK THRESHOLDS BY BOND TYPE AND RATING

Type of bond	Rating	Concentration threshold
Corporate bonds, sub + hybrid debt, ABS, CDO	AAA – AA	3.0%
	A	3.0%
	BBB	1.5%
	BB or lower	1.5%
Covered Bonds	AAA – AA	15.0%
Exposure to EEA state, multilateral development banks, international organisations, ECB		none

Source: EIOPA, Crédit Agricole CIB

BOTTOM LINE

Solvency II is probably the regulatory regime in which ratings still play the biggest role and in which sovereign debt is given the biggest advantage over private-sector debt. It is true that in bank regulation EU member states do have a 0% RW; but since Solvency II is calibrated for long-term investors and covers credit risk as well as market volatility risk, the absolute capital charges are a multiple of those for banks and relative differences are magnified.

Apart from the comparison with sovereign debt, highly rated UCITS-compliant covered bonds do fare relatively well overall. They get preferential treatment in both the spread risk and concentration risk modules as long as they are rated at least AA−. Non-UCITS-compliant covered bonds are treated as senior unsecured exposure but as long as they are highly rated, at least capital charge differences to UCITS-compliant covered bonds are not major. Capital charges do, however, start to go up the moment ratings drop to below AA−, as even UCITS-compliant covered bonds are then treated as senior unsecured exposure from A+ onwards. While the step to single A ratings is still manageable, dropping to BBB and below means that capital charges become very onerous.

In addition to the spread risk capital treatment, overall capital charges under Solvency II are also determined by the size of the asset–liability mismatch. And long-dated covered bonds are an asset class that is able to close the gap to insurance companies' long-dated liabilities while giving the added security of the underlying framework, product support and collateral.

In our view, covered bonds will thus maintain an integral part of insurance companies' investments despite the disadvantage to sovereign debt.

The bigger problem for insurance companies these days are low yields overall, something that is not specific to covered bonds. Insurance companies' share in covered bond new issues has come down in the last two years as yields have dropped. Initially they tried to move into the lower-rated still higher-yielding products, but as spreads have compressed across sectors and issuers, activity levels by insurance sector investors in covered bond space has clearly taken a hit for the time being.

Solvency II is not going to keep insurance accounts from buying covered bonds again (apart from maybe conditional pass-through ones), but it will require higher yield levels overall to reignite the flame.

2.3 THE REPO TREATMENT OF COVERED BONDS BY CENTRAL BANKS

By Frank Will, HSBC & Chairman of the ECBC EU Legislation Working Group

I. CENTRAL BANK REPOS: THE SAFETY NET FOR THE BANKING SYSTEM

Since the onset of the financial markets crisis, central banks worldwide have stepped in, putting in place a number of measures to backstop the banking system. Wide-scale unsterilized asset purchases (Quantitative Easing, QE) have been extensively used by the Federal Reserve and the Bank of England. The European Central Bank (ECB) responded with two covered bond purchase programmes initiated in mid-2009 and in late-2011. A crucial pillar of the responses of almost all central banks has been their monetary policy operations, either by increasing the number or nature of their short and long term repo operations such as the two 3-year Long-Term Refinancing Operations (LTROs) from the ECB in December 2011 and in February 2012, or by widening the pool of repo eligible collateral. The targeted LTROs announced by the ECB back in June 2014 and the expanded asset purchase programme (EAPP), including the third covered bond purchase programme (CBPP3), however, aim at enhancing the functioning of the monetary policy transmission mechanism by supporting bank lending to the real economy rather than being a direct response to the financial market crisis.

The role of covered bonds in monetary operations varies by jurisdiction, not least since the nature of those operations is quite heterogeneous across jurisdictions. Broadly speaking, covered bonds receive more favourable treatment amongst those countries in which they play a more pivotal role in the funding of the domestic banking sector. This applied primarily in terms of eligibility of covered bonds as collateral for repo operations, but also in terms of the haircuts applied. At many of the major central banks (at least some types of) covered bonds are eligible as collateral in the discount window for emergency lending.

> Figure 1: Comparing the eligibility of covered bonds for monetary policy operations

Central Bank	Operation	Covered Bonds eligible?	Eligible Covered Bonds	Currency	Minimum Rating	Rating Treatment	Minimum Size	Own-name Covered bonds?
ECB	Repo Operations (Main and Long term refinancing operations)	Yes	Covered bonds compliant with UCITS Article 52(4) or similar safeguards	EUR, USD, GBP, JPY[1]	Up to BBB-	Best Rating	EUR 1 bn for Jumbo Covered Bonds, otherwise none	Yes
Fed	SOMA Operations	No	None	USD	n/a	n/a	n/a	n/a
	Discount Window	Yes	US Covered Bonds	AUD, CAD, CHF, DNK, EUR, GBP, JPY, SEK	BBB	Lowest Rating	n/a	No
			German Pfandbriefe		AAA			
BoE	Operating Standing Facilities, Short term OMOs	No	n/a	GBP, EUR, USD, AUD, CAN, CHF, SEK	n/a	n/a	n/a	n/a
	Level B Collateral (ILTR, DWF, CTRF and FLS)	Yes	UK, French, German & Spanish regulated covered bonds		Broadly equivalent to AAA	Rating references are indicative. Bank of England forms its own independent view	GBP 1 bn or EUR 1 bn (depending on issuance currency)	No
	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	Yes

[1] Foreign currency-denominated debt instruments constitute eligible collateral for Eurosystem credit operations from 9 November 2012 onwards, subject to the fulfillment of the relevant eligibility criteria. In addition to the haircuts applicable to similar EUR-denominated securities, a further mark-down will be applied (16% for USD and GBP, 26% for JPY).

Central Bank	Operation	Covered Bonds eligible?	Eligible Covered Bonds	Currency	Minimum Rating	Rating Treatment	Minimum Size	Own-name Covered bonds?
SNB	Repo operations, Standing Facilities	Yes From 2015 on, Covered Bonds must be eligible under the Swiss LCR framework	Any covered 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	CHF 100 m equivalent (issuance amount)	No
			Any covered 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 Issuer's country: AA-/Aa3		CHF 1 bn equivalent (issuance amount)	
Norges Bank	Repo Operations	Yes	Any covered fulfilling the eligible security criteria	NOK, SEK, DKK, EUR, USD, GBP, JPY, AUD, NZD, CHF	Domestic currency: None but BBB- for favourable liquidity category (II not III)	Best Rating	None	Yes
					Foreign Bonds: A/A2			
Reserve Bank of Australia (RBA)	Repo Operations	Yes	Any covered bond fulfilling the eligible security criteria	AUD	AAA or BBB+ for domestic covered bonds >1Y	Lowest Rating	None	No
Reserve Bank of New Zealand (RBNZ)	Repo and/or Swap of NZ Government Bonds	No	None	n/a	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	Yes	Canadian covered bonds	CAD	At least two ratings, second highest must be at least A (low) by DBRS, A3 by Moody's, or A- by S&P or Fitch.		n/a	No

Source: HSBC, Central Banks

II. EURO AREA: ELIGIBILITY CRITERIA FOR COLLATERAL IN EUROSYSTEM OPERATIONS

The ECB has been a key source of liquidity for banks in the Eurosystem during the credit crunch and the European debt crisis through its repo operations. Within the ECB's liquidity operations, covered bonds play an increasingly important role. While in certain periods during the sovereign and banking crisis the benchmark covered bond market was shut for many issuers out of Europe's periphery the ECB continued to provide liquidity to those banks. Measures of this type include the two 3-year long-term refinancing operations the ECB conducted in December 2011 and in February 2012. Banks took more than EUR 1 trn in gross liquidity – backed by eligible collateral. Many covered bond programmes have been set up not just as an additional funding channel, but also in order to allow the banks to use the repo facilities at the ECB as means to access liquidity in a closed wholesale market.

After reviving the covered bond market back in 2009 with its EUR 60 bn purchase programme, the ECB has seen covered bonds being one of the fastest growing assets in terms of collateral posted, tripling amounts posted in the 5-year period from 2007 to 2012 and largely exceeding the overall increase in total collateral posted for repo operations. However, over the last three years, the posted covered bond volume has dropped by about a third in line with overall volumes. See the section below for a more detailed discourse on covered bond usage in ECB operations and the ECB classification of a "covered bank bond".

ECB repo operations

Article 18.1 of the Statute of the European System of Central Banks and of the European Central Bank states that the ECB and the national central banks may conduct credit operations with credit institutions and other market participants, as long as lending is "based on adequate collateral".[2] According to the ECB, adequacy means firstly, that collateral must protect against losses in credit operations, and secondly, that there must be sufficient collateral potentially available to ensure that the Eurosystem can carry out its tasks.

Consequently, underlying assets have to fulfil certain criteria in order to be eligible for Eurosystem monetary policy operations. The Eurosystem has developed a single framework for eligible assets common to all Eurosystem credit operations (the "single list"). There is no collateral differentiation between monetary policy instruments or intraday credit, and a single auction rate is applicable to different types of collateral in tender operations. The scope of eligible collateral is broad and includes secured assets like covered bonds and ABS, the latter of which can be backed by receivables such as residential and commercial loans (secured and unsecured), auto loans, lease receivables etc., provided they satisfy certain eligibility criteria (set out below), as well as unsecured claims against governments, credit institutions or corporates. In February 2012, the ECB approved, for seven national central banks (Ireland, Spain, Portugal, Italy, Cyprus, France and Austria) specific national eligibility criteria to accept additional performing credit claims as collateral. In February 2015, the ECB stated that the rating waiver for debt instruments issued or fully guaranteed by Greece would be waived making these bonds effectively no longer eligible.

The Eurosystem additionally applies risk control measures in the valuation of underlying assets. The value of the underlying asset is calculated as the market value of the asset less a certain percentage ("valuation haircut"). The haircut-adjusted market value of the underlying assets used in its liquidity-providing reverse transactions must be maintained over time. This implies that if the value, measured on a regular basis, of the underlying assets falls below a certain level, the national central bank will require the counterparty to supply additional assets or cash (i.e. it will make a margin call). Similarly, if the value of the underlying assets, following their revaluation, exceeds a certain level, the counterparty may retrieve the excess assets or cash. The current eligibility of assets in the ECB framework and recent changes to this are set out below:

[2] Protocol on the Statute of the European System of Central Banks and of the ECB, Article 18.1.

> Figure 2: Eligibility of assets in the ECB framework

Criteria	Standard Collateral Rules
Type of Asset	> Debt instrument having a coupon that cannot result in a negative cash flow > Coupon should be zero coupon, fixed-rate coupon, multi-step coupon or floating-rate coupon linked to an interest rate reference or yield of one euro area government bond with a maturity of one year or less or inflation-indexed > Debt instruments, including covered bonds, but not including ABS, must have a fixed, unconditional principal amount
Definition of Covered Bonds	> The ECB does not provide an official definition of what they classify as covered bonds in the context of eligible collateral > In general, 'Covered Bank Bonds' for ECB collateral purposes means bonds issued in accordance with Article 52 (4) of the UCITS Directive, (i.e. subject to covered bond specific legislation) or similar safeguards > Covered bonds with external, non-intra group MBS as well as both internal and external public sector ABS in the cover pool are no longer eligible as collateral for repo transactions
Cash Flow Backing ABS	> Must be legally acquired in accordance with the laws of a member state in a "true sale" > Must not consist of credit-linked notes (i.e. cannot be a synthetic structure), or contain tranches of other ABS
Tranche and Rating	> Tranche (or sub-tranche) must not be subordinated to other tranches of the same issue > The minimum rating threshold is BBB- (S&P) / Baa3 (Moody's) / BBB- (Fitch) / BBBL (DBRS) based on a "best rating approach", so only one rating at this level is required for eligibility > The minimum ratings for ABS are A- (S&P) / A3 (Moody's) / A- (Fitch) / AL (DBRS) on a second-best basis. Certain ABS fulfilling additional requirements could qualify if they have at least two triple-B ratings
Place of Issue	> European Economic Area (EEA)
Settlement Procedures	> Transferable in book-entry form > Held and settled in the euro area
Acceptable Market	> Debt instrument must be admitted to trading on a regulated market or a non-regulated market as specified by the ECB
Type of Issuer/ Guarantor	> Central banks, public sector or private sector entities or international institutions
Place of Establishment of the Issuer/ Guarantor	> Issuer must be established in the EEA or in non-EEA G10 countries and guarantors must be established in the EEA
Currency of Denomination	> EUR, USD, GBP, JPY[3]

Source: HSBC, ECB

In January 2011, the ECB implemented its new haircut scheme, graduating haircuts according to differences in maturities, liquidity categories and the credit quality of the assets concerned (see Figure 3 & 4). The Governing Council also decided to retain the minimum credit threshold for marketable and non-marketable assets in the Eurosystem collateral framework at investment grade level.

[3] Foreign currency-denominated debt instruments constitute eligible collateral for Eurosystem credit operations since 9 November 2012. This measure reintroduces a similar decision applicable between October 2008 and December 2010. In addition to the haircuts applicable to similar EUR-denominated securities, a further mark-down will be applied (16% for USD and GBP, 26% for JPY).

In June 2012, the ECB further increased the collateral availability of ABS, when it lowered the minimum rating threshold to "BBB-" (second-best) from "A-". Based on the amended haircut schedule, ABS with ratings below "A-" fulfilling additional requirements are subject to higher haircuts of 22%.

In September 2012, the ECB decided that marketable debt instruments denominated in currencies other than EUR, namely USD, GBP and JPY, and issued and held in the euro area, are eligible as collateral until further notice. This measure reintroduces a similar decision applicable between October 2008 and December 2010, with appropriate valuation markdowns. Covered bonds with external, non-intra group MBS as well as both internal and external public sector ABS in the cover pool are no longer eligible as collateral for repo transactions (since 31 March 2013). However, the ECB granted a grandfathering period of two years until 28 November 2014 for already issued covered bonds. As of 1 March 2015, own-name covered bonds where the asset pool contains own-name uncovered government-guaranteed bank bonds will no longer be accepted by the Eurosystem.

In July 2013, the ECB amended again its haircut schedules. One of the biggest changes was the reduction of the haircut for ABS from 16% to 10%. Several haircuts for other assets classes were also lowered, though by significant smaller margins. In case of triple-B rated assets, the haircuts for assets in liquidity category I and II were increased whilst the haircuts of liquidity category III and IV were slightly reduced.

> Figure 3: ECB haircuts by liquidity category and residual maturity[4]

Credit Quality Steps 1 and 2 (AAA to A-)	**Liquidity Category I** (Government Bonds)		**Liquidity Category II** (Local & Regional Govt, Supras & Agencies, Jumbo Covered Bonds*)		**Liquidity Category III** (Traditional Covered Bonds*, Structured Covered Bonds*, Multi-Issuer Covered Bonds* Corporates Bonds*)		**Liquidity Category IV** (Unsecured Bank Bonds*)		**Liquidity Category V** (ABS*)
Residual maturity (years)	**Fixed coupon**	**Zero coupon**	**Fixed coupon**	**Zero coupon**	**Fixed coupon**	**Zero coupon**	**Fixed coupon**	**Zero coupon**	**Fixed or zero coupon**
0-1	0.5	0.5	1.0	1.0	1.0	1.0	6.5	6.5	10.0
1-3	1.0	2.0	1.5	2.5	2.0	3.0	8.5	9.0	
3-5	1.5	2.5	2.5	3.5	3.0	4.5	11.0	11.5	
5-7	2.0	3.0	3.5	4.5	4.5	6.0	12.5	13.5	
7-10	3.0	4.0	4.5	6.5	6.0	8.0	14.0	15.5	
>10	5.0	7.0	8.0	10.5	9.0	13.0	17.0	22.5	

Source: ECB

*Assets that are given a theoretical value will be subject to an additional 5% haircut; additional valuation markdowns for own-use covered bonds (8% for CQS1&2 and 12% for CQS3).

[4] Haircuts of variable rate debt instruments included in liquidity categories I to IV, excluding "inverse floaters", will be those applicable to the 0-1 year maturity bucket of fixed coupon instruments in the corresponding liquidity and credit category.

> Figure 4: ECB haircuts by liquidity category and residual maturity

Credit Quality Step 3 (BBB+ to BBB-)	**Liquidity Category I** (Government Bonds)		**Liquidity Category II** (Local & Regional Govt, Supras & Agencies, Jumbo Covered Bonds*)		**Liquidity Category III** (Traditional Covered Bonds*, Structured Covered Bonds*, Multi-Issuer Covered Bonds*, Corporates Bonds)		**Liquidity Category IV** (Unsecured Bank Bonds*)		**Liquidity Category V** (ABS)
Residual maturity (years)	**Fixed coupon**	**Zero coupon**	**Fixed coupon**	**Zero coupon**	**Fixed coupon**	**Zero coupon**	**Fixed coupon**	**Zero coupon**	**Fixed or zero coupon**
0-1	6.0	6.0	7.0	7.0	8.0	8.0	13.0	13.0	22
1-3	7.0	8.0	10.0	14.5	15.0	16.5	24.5	26.5	
3-5	9.0	10.0	15.5	20.5	22.5	25.0	32.5	36.5	
5-7	10.0	11.5	16.0	22.0	26.0	30.0	36.0	40.0	
7-10	11.5	13.0	18.5	27.5	27.0	32.5	37.0	42.5	
>10	13.0	16.0	22.5	33.0	27.5	35.0	37.5	44.0	

Source: ECB

*Assets that are given a theoretical value will be subject to an additional 5% haircut; additional valuation markdowns for own-use covered bonds (8 % for CQS1&2 and 12% for CQS3).

Classification of covered bonds within the Eurosystem operations

The ECB considers covered bonds to be a relatively liquid asset class. Hence, covered bonds benefit from preferential liquidity class classification and favourable haircut valuations for repo transactions with the ECB when compared with, for example, ABS. Moreover, unlike senior bank debt (and government-guaranteed senior bank debt from 2015), the ECB will accept self-issued "covered bank bonds" as collateral (see below for more information on this). Thus, like certain forms of ABS, covered bonds allow issuers to make assets held on their balance sheets eligible for the ECB's liquidity operations. This is very much in line with previous ECB statements which note that "covered bonds possess a number of attractive features from the perspective of financial stability".

The Eurosystem does currently not provide an official definition of what is classified as "covered bond". In general, the Eurosystem accepts both UCITS and non-UCITS compliant covered bonds as collateral as long as they otherwise fulfil the general eligibility criteria. Generally, debt instruments are classified as "covered bank bonds" if they are issued in accordance with the criteria set out in Article 52(4) of the UCITS Directive. Those bonds are grouped either into liquidity category II in case of Jumbo covered bonds, i.e. bonds with a minimum issue size of EUR 1 bn and at least three market makers, or into liquidity category III in case of traditional non-Jumbo covered bonds. Over the last few years, the market has moved away from the "Jumbo" definition and we would not be surprised if the ECB were to also update its internal criteria at one stage.

"Structured" covered bonds are issued under a general legal framework, rather than being subject to "special public supervision", they do not fall within the UCITS definition and as such have not been recognised as covered bank debt by the ECB from a liquidity haircut perspective and in the past were assigned to category IV similar to senior unsecured bank debt. However, since 1 January 2011 all non-Jumbo covered bonds, including "structured covered bonds" and multi-issuer covered bonds, together with traditional (UCITS-compliant) covered bonds, have been classified in liquidity category III. As of August 2015, also all Spanish covered bonds – including single name bonds – are classified as Category III securities. Interestingly, the ECB has classified Commerzbank's inaugural EUR 500 mln SME covered bond issued in February 2012 as "structured covered bond" and has put it into Liquidity Category III next to other non-Jumbo covered bonds.

For "structured covered bank bonds" there are additional requirements, including the following: (1) substitution asset limit of 10%, which can be exceeded at the discretion of the National Central Bank, (2) maximum LTV limit of 80% for residential and 60% for commercial mortgages, (3) minimum mandatory OC of 8% for residential and 10% for commercial mortgages, (4) maximum loan amount for residential real estate loans of EUR 1mln, (5) covered bond must have a long-term minimum rating of A-/A3. Covered bonds with external, non-intra group MBS as well as both internal and external public sector ABS in the cover pool are no longer eligible as collateral for repo transactions (since 31 March 2013). As of 1 March 2015, own-name covered bonds where the asset pool contains own-name uncovered government-guaranteed bank bonds are no longer accepted by the Eurosystem.

Covered bonds and "close link" exemption

"Covered bank bonds" also benefit from certain preferential treatments compared with other bank debt when it comes to self-issued bonds. The ECB states that "irrespective of the fact that a marketable or non-marketable asset fulfils all eligibility criteria, a counterparty may not submit as collateral any asset issued or guaranteed by itself or by any other entity with which it has close links"[5]. This means that banks cannot, for example, use their own senior unsecured debt directly as collateral with the ECB.

In the past, issuers were able to securitise assets on their balance sheet and retain them as collateral for central bank repo operations. However, in addition to certain other changes outlined below, as a result of the increased use of securitisation technology to create ABS assets solely for use as collateral for central bank liquidity purposes, the ECB broadened the definition of 'close links'. The definition now also extends to situations where a counterparty submits an asset-backed security as collateral when it (or any third party that has close links to it) provides support to that asset-backed security by entering into a currency hedge with the issuer or guarantor of the asset-backed security or by providing liquidity support of more than 20% of the nominal value of the asset-backed security.

The main exemptions from the "close links" rule remain "covered bank bonds". Self-issued UCITS compliant covered bonds (as well as structured covered bank bonds, subject to strict additional criteria, as outlined above) can be used by counterparties as collateral, i.e. an issuer can use its own covered bonds and there are no close link prohibitions. This has been one of the drivers of the strong increase in new covered bond programmes since 2008.

In November 2012, the ECB amended the close-link provisions regarding own-use of covered bonds as collateral. As of now only CRD compliant covered bonds and UCITS compliant covered bonds that offer comparable protection are eligible. Our understanding is that some of the structured CB programmes that have been used for ECB funding but are not UCITS compliant may cease to be eligible if retained and submitted (close-links).

In February 2015, the ECB clarified that the own-use rules for multi-cédulas issued after 1 May 2015 will consider the relation between each of the underlying cédulas issuers and respective counterparties for determining the existence of close links.

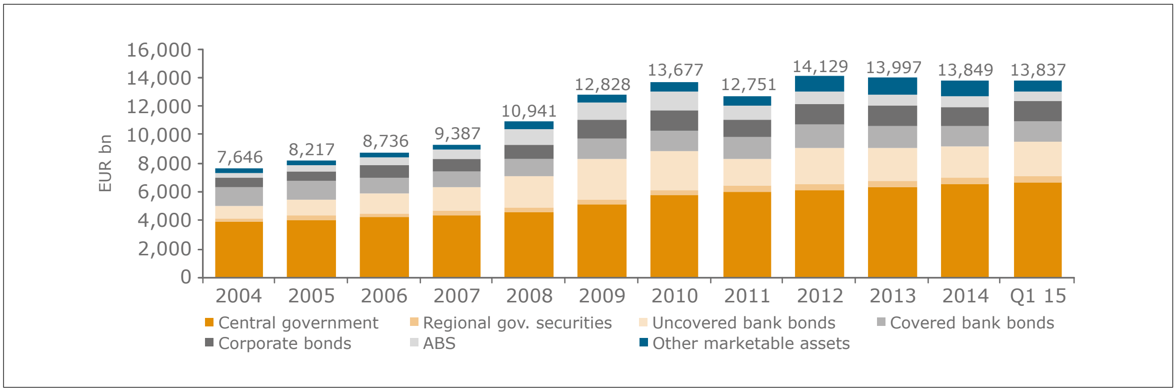
Use of covered bonds as collateral in Eurosystem operations

The overall volume of marketable assets which had become eligible for repo operations had increased over 80% from EUR 7.6 trn in 2004 to EUR 13.7 trn at year-end 2010. In 2011, the eligible collateral volume decreased for the first time – by circa EUR 1 trn. Since then, the volume has remained more or less stable at around EUR 14 trn. At the end of Q1 2015, central government debt accounted for the largest share (48%), followed by uncovered bank bonds (18%), covered bank bonds (10%), corporate bonds (10%) and ABS (5%). Other bonds and regional government securities make up 9%.[6]

[5] "Close links" means the counterparty is linked to an issuer/debtor/guarantor of eligible assets by one of the following forms:(i) the counterparty owns directly, or indirectly, through one or more other undertakings, 20 % or more of the capital of the issuer/debtor/guarantor; or (ii) the issuer/debtor/guarantor owns directly, or indirectly through one or more other undertakings, 20 % or more of the capital of the counterparty; or (iii) a third party owns more than 20 % of the capital of the counterparty and more than 20 % of the capital of the issuer/debtor/guarantor, either directly or indirectly, through one or more undertakings [ECB, "The Implementation on Monetary Policy in the Euro Area", February 2011].

[6] Although included within the list of eligible collateral, the volume of potentially eligible non-marketable assets is difficult to estimate since the eligibility of credit claims (the largest share of non-marketable assets) are not assessed until they are registered with the Eurosystem.

> Figure 5: Eligible collateral by asset type



Source: ECB, HSBC

The actual breakdown by type of the collateral used for repo transaction differs significantly from the market composition of the available eligible collateral as relative value considerations play an important role in the banks' decisions as to which collateral to post.

During the financial crisis there was a general trend to lower the overall quality and/or liquidity of the collateral used by the banks for repo operations. The share of central government debt fell sharply from 31% in 2004 to just 10% in 2008; however, this trend has reversed over the last few years and the government share has increased to 20% as of Q1 2015.

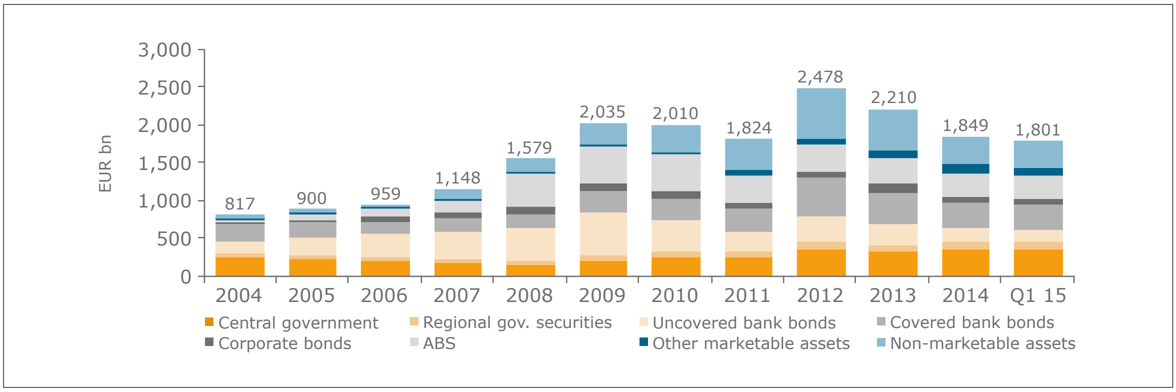
The use of covered bank bonds in the Eurosystem repo operations dropped from 26% in 2004 to 11% in 2008. Since then it increased again and stood at 18% as of Q1 2015.

The share of uncovered bank bonds has continuously dropped from 32% in 2007 to just 9% as of Q1 2015.

ABS grew from 6% in 2004 to 28% in 2008 before stabilising at 23% and 24% in 2009 and 2010 respectively. Their level decreased again to 17% as of end Q1 2014.

Figure 6 also shows the large rise in the main and long-term refinancing operations of the Eurosystem banks in autumn 2008 and then an even larger increase during the course of 2009. Total usage stabilised in 2010 and declined in 2011 before marking new heights in 2012 at EUR 2.5 trn thanks to the large LTROs. As of Q1 2015, the volume has dropped again to EUR 1.8 trn.

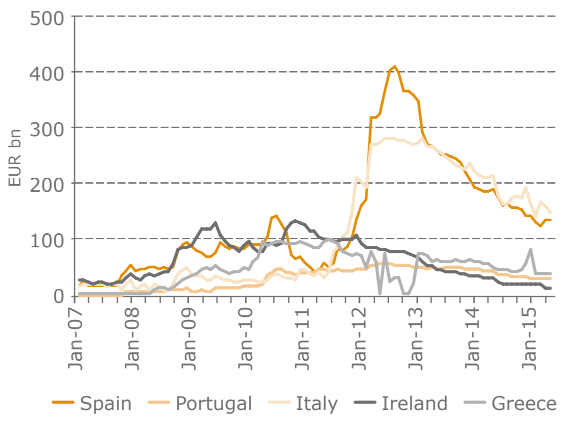
> Figure 6: Actual use of collateral by asset type



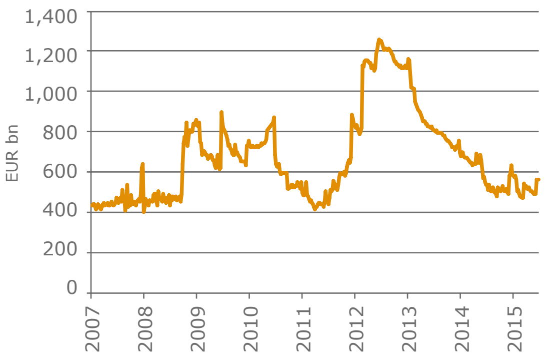
Source: ECB, HSBC

Only some of the European central banks publish figures relating to the national usage of repo facilities. Nonetheless, these clearly show that whilst banks increased their usage of the ECB facility since the beginning of the credit crunch, with the onset of the sovereign crisis the composition of the banks using the facility has changed significantly with a disproportionally high increase in usage of ECB repo facilities from banks in the periphery. Figures by the national central banks show that the usage of the central bank facilities by banks out of Europe's periphery has significantly increased since 2011 until the peak of June 2012. The ECB remains an important funding channel for many peripheral banks, which have seen their share consistently increase on a relative basis, even as absolute levels declined.

> Figure 7a: Composition of Eurosystem lending to euro area credit institutions



> Figure 7b: Total Eurosystem lending to euro area credit institutions



Source: Eurosystem, Bloomberg, HSBC

Targeted LTRO

In June 2014, the ECB announced a series of targeted longer-term refinancing operations (TLTROs) which will be conducted over a window of two years and are designed to enhance the functioning of the monetary policy transmission mechanism by supporting bank lending to the real economy. The interest rate on the TLTROs will be fixed over the life of each operation at the rate on the Eurosystem's main refinancing operations (MROs) prevailing at the time of take-up, plus initially a fixed spread of 10 basis points. The 10 basis point fee was dropped in January 2015 to make the instrument more attractive. In the TLTROs, the same Eurosystem collateral rules apply (in relation to eligibility criteria, valuation, haircuts and rules on the use of eligible assets) as in other refinancing operations, i.e. repo-eligible covered bonds can also be posted as collateral.

Conclusion on covered bond treatment

The ECB, to a greater extent than any of its central bank peers, has both outlined and demonstrated its support in the past for the covered bond market. This was most obviously the case with its highly successful EUR60bn covered bond purchase programme in 2009/2010, but was also underlined with smaller second purchase programme in late 2011 and the third programme that started in October 2014 which exceeds already the aggregated amounts of the previous two programmes. Perhaps even more important is the ECB's positive stance towards covered bonds, which the institution maintains for several reasons.

Firstly the ECB has focussed on the importance of covered bonds as a means for banks of accessing long term funding: "Issuing covered bonds enhances a bank's ability to match the duration of its liabilities to that of its mortgage loan portfolio, enabling a better management of its exposure to interest rate risk. Other secured funding products, such as repos, are unlikely to have the same asset-liability matching attributes offered by covered bonds. All these issues are all the more important today given the increasing role of short-term refinancing in banks' balance sheets. In certain instances, rolling over short-term funding might be less expensive or better in terms of reputation, but this could pose challenges to the management of assets and liabilities at some point. In addition to improving banks' structural asset-liability mismatch, covered bonds offer a wider geographical diversification, as issuers tap into a larger European market."[7] Moreover, a further key advantage comes from the absence of effective risk transfer and the desirable incentives this creates for the originating banks. As former ECB president Trichet noted: "importantly, covered bonds do not involve the transfer of the credit risk implied by underlying assets from the issuer to the investor. The credit risk stays with the originator, preserving the incentives for prudent credit risk evaluation and monitoring."[8]

Such positive attitude is reflected (i) in the ECB's current favourable treatment of covered bonds within its repo operations as they are allocated in a very favourable liquidity category (Jumbo covered bonds rank alongside the debt of the ESM, EIB and the explicitly guaranteed German agency KfW) and (ii) in the ongoing changes the ECB implements to these operations, for example the re-classification of liquidity category and more favourable haircuts applied to 'structured covered bonds' and 'multi-issuer covered bonds' since the beginning of 2011. At the same time, the ECB has tightened the requirements back in November 2012 to ensure the quality of the covered bonds posted as collateral.

III. THE UK: ELIGIBILITY CRITERIA FOR BANK OF ENGLAND OPERATIONS

Latest changes to the framework

In October 2014, the Bank of England introduced the concept of collateral pooling to simplify the management of the collateral it received by the banks for its monetary operations. In the past, liquidity was provided against collateral by way of repurchase transactions. The new approach allows participants to pool their collateral across certain facilities (e.g. Short-Term Open Market Operations (OMOs), Operational Standing Facilities (OSFs), Indexed Long Term Repo operations (ILTRs), Discount Window Facility (DWF) and Intra-Day Liquidity (IDL) for RTGS). The Bank of England expects the pooling model to simplify the process for managing the collateral, enhance operational efficiency and reduce operational risks.

Before the introduction of the Single Collateral Pool (SCP) model, the Bank of England's SMF and intraday liquidity operations were repo transactions whereby individual securities were held as collateral against the central bank's exposures to that participant. The SCP model aggregates a participant's collateral position thereby significantly reducing the volume and frequency of transactions needed to provide collateral to the Bank of England.

The Bank of England has established two active collateral pools: the Main Collateral Pool and the DWF pool. In addition, there is a 'Pre-positioned pool for loan collateral' for loans meeting the collateral eligibility requirements but have not yet been used to cover any transactions. The Funding for Lending Scheme (FLS) already operates on a collateral pooling basis and will remain as a separate pool for the time being.

Covered bonds under the Sterling monetary framework

The Bank of England (BoE) operates a rather stricter regime than the ECB in terms of eligible collateral within the Sterling Monetary Framework. The BoE defines three collateral sets, which are eligible to varying degree for its monetary operations: (1) level A collateral set, (2) level B collateral set, (3) level C collateral securities as well as level C loan collateral.

[7] European Central Bank, "Covered Bonds in the EU Financial System", December 2008.

[8] Keynote address by Jean-Claude Trichet, Munich, 13 July 2009.

Within the Sterling monetary framework operations, covered bonds are only included within the Level B and Level C collateral securities sets, both of which are eligible for the following facilities: (1) Indexed Long-Term Repo OMOs, (2) Discount Window Facility, (3) Contingent Term Repo Facility as well as (4) the Funding for Lending Scheme.

The eligibility criteria for covered bond inclusion can be found below:

> Figure 8: Bank of England's covered bond eligibility criteria

	Level B	Level C Collateral Securities
Eligible currencies	GBP, EUR, USD, AUD, CAN, CHF, and SEK	
Geography	UK, French, German and Spanish regulated Covered Bonds	UK, US and EEA covered bonds, including covered bonds backed by Export Credit Agency (ECA) guaranteed loans (subject to individual review)
Rating Requirements	Broadly equivalent to AAA	Broadly equivalent to A3/A- or higher
Minimum Size	At least £1bn or €1bn (depending on issue currency)	n/a
Own Name Covered Bonds	No	Yes
Underlying assets	UK or EEA residential mortgages, social housing loans or public sector debt	UK or EEA residential mortgages, or public sector debt, social housing loans, SME loans, commercial mortgages from the UK, the US, EAA. ECA guaranteed loans from the UK, the US and EEA

Source: Bank of England, HSBC

Rating references are only used to indicate the broad standards of credit quality that are expected by the Bank of England and are no longer prerequisites for eligibility. The BoE rather forms its own independent view of the risk in the collateral taken and only accepts collateral that it can value and where the risk can be effectively managed.

For the Level B collateral set, only a subset of the covered bond universe is eligible. The criteria are based on a combination of both credit quality (hence underlined by the AAA rating-equivalent requirement) and liquidity. For example, covered bonds from Nordic issuers, one of the core covered bond markets with an acknowledged safe haven status, are not included in the Level B Collateral Set, whereas Spanish covered bonds are generally included but probably do not fulfil the minimum rating (equivalent) requirement at the moment. Meanwhile, under the current guidelines, even for some of the UK banks, their Euro covered bonds would mainly be eligible, given that many Sterling covered bonds fall below the minimum issue size threshold of GBP 1bn.

Covered bonds do not qualify for the Bank of England's Level A collateral set which is restricted to Gilts (including gilt strips), Sterling Treasury bills, Bank of England securities, HM Government non-sterling marketable debt and Sterling, euro, US dollar and Canadian dollar-denominated securities (including associated strips) issued by the governments and central banks of Canada, France, Germany, the Netherlands and the US.

In 2011, bonds issued in domestic currency or in sterling, euro or US dollars from Australia, Austria, Belgium, Denmark, Finland, Italy, Japan, Luxembourg, New Zealand, Norway, Portugal, Slovenia, Spain, Sweden, and Switzerland, as well as supranational debt, were moved from the "narrow" (now called Level A) to the "wider" (now called Level B) collateral set and are therefore not eligible for short term repo operations. Thus, even some AAA countries such as Norway, Denmark or Finland are no longer eligible for short-term repos under the Level A collateral definition. These amendments were the result of a previous internal review by the BoE, reflecting a stronger focus on liquidity and credit risk.

> Figure 9: Haircuts for various covered bond types

	float.	<1 yr	1-3 yrs	3-5 yrs	5-10 yrs	10-20 yrs	20-30 yrs	>30 yrs
Covered bonds (backed by UK or EEA public sector debt, social housing loans or residential mortgages)	12	12	14	15	17	19	22	24
UK, EEA or US covered bonds (backed by SME loans or commercial mortgages)	25	25	27	28	30	32	35	37
UK, EEA or US covered bonds (backed by ECA guaranteed loans)	3	3	5	6	8	10	13	15

Source: HSBC

As mentioned above, the Bank of England conducts a number of different monetary policy and liquidity insurance operations. Figure 10 below shows the eligibility of different collateral sets for the various operations and facilities:

> Figure 10: Eligibility of different collateral sets for the various operations and facilities

Sterling Monetary Framework operations & lending facilities	Level A	Level B	Level C
Real Time Gross Settlement	Yes	No	No
Operational Standing Facilities	Yes	No	No
Short-term Repo OMOs	Yes	No	No
Indexed Long-term Repo Operations	Yes	**Yes**	**Yes**
Discount-Window Facility	Yes	**Yes**	**Yes**
Contingent Term Repo Facility	Yes	**Yes**	**Yes**
Funding For Lending Scheme	Yes	**Yes**	**Yes**

Source: Bank of England, HSBC

Operational standing facilities

The Operational Standing Lending Facility provides a ceiling for the overnight interest rates through its overnight lending facility (against the Level A collateral set), which is usually set at 25bp above the Bank of England rate. The Operational Standing Deposit Facility is an unsecured overnight deposit with the central bank, which is currently set 50 bps below the Bank of England rate. This is designed to limit volatility in overnight interest rates by providing an arbitrage mechanism to prevent money market rates moving far from the bank rate and allowing participating banks to manage unexpected frictional payment shocks.

Short-term open market operations (OMOs)

Short-term Open Market Operations (OMOs) are designed to supply the quantity of reserves consistent with the aggregate target set by the banks for that maintenance period (the period over which compliance with reserve requirements is calculated) under the reserve averaging process. These operations have been suspended since March 2009 as a result of the BoE's asset purchase scheme (QE), so the supply of reserves is currently determined by the level of reserves. At the moment the BoE is operating a "floor system" where all reserves are remunerated at the Bank Rate.

Indexed long-term repo operations

Indexed long-term repo operations are provided by the Bank of England to provide indexed liquidity insurance without distorting banks' incentives for prudent liquidity management and to minimise the risk being taken onto the BoE's balance sheet. These operations are indexed to the bank rate, allowing counterparties to use the facility without having to take a view on the future path of the Bank rate (and also reducing the BoE's exposure to market risk). In these operations banks can borrow against three collateral sets: Levels A, B and C. Levels B and C include covered bonds meeting the aforementioned criteria. Level C securities must be delivered to the Bank in advance of the operation, and all loan collateral must be pre-positioned.

The BoE typically offers funds in long-term repo operations once a month. Since 2014 the term of all ILTR lending has been extended to six months.

The BoE does not provide a simple schedule of long-term operations, as is the case for the ECB. Instead it operates a unique auction design. Participants submit bids for a nominal amount of liquidity and a spread in basis points to the bank rate. Banks can submit separate bids against Level A collateral or against Level B and C collateral (where covered bonds are eligible). Multiple bids can be placed against any of the three collateral sets[9].

The auction then prices using a "uniform price" format, meaning all successful bidders (those bidding for liquidity at a higher price than the clearing spread) ultimately pay only the clearing spread.[10] The BoE specifies the clearing spreads for all the three collateral sets. Bids are ranked and accepted in descending order of the bid spread until the BoE's supply preferences have been met. Thus, when pledging covered bonds in the BoE's long-term indexed repo operations, the ultimate cost to a bank will depend on the spread set for the Levels B and collateral sets in the auction. Crucially, the auction is flexible as both the proportion of the total amount allocated to each collateral set as well as the total quantity of funds are based on the pattern of bids received. This determines the amount of liquidity, against which covered bonds can potentially be pledged. So in this system the amount of liquidity on offer against the Level B and C collateral sets depends not only on demand for long-term repos on these assets but also on those in the Level A collateral set.

Discount window facility

The discount window is a bilateral facility used for emergency lending to an institution; providing liquidity insurance. It allows participants to borrow Gilts (or in extreme cases even cash) against a wider range of potentially less liquid eligible collateral. It acts as a "liquidity upgrade of collateral", hence, the wider range of eligible collateral. Fees are paid when the Gilts are returned to the BoE in return for the original assets. Drawings have a 30-day maturity and can be rolled for longer temporary liquidity needs.

Collateral, which can be pledged, encompasses all the collateral sets Level A, B and C. The fees charged for the discount window depend upon the type of collateral used and the proportion of eligible liabilities, which the lending would represent.

For lending provided in return for Gilts[11] the fees (in basis points) for the different categories of collateral are set out below:

[9] There is no restriction on the number of bids, the aggregate value of bids or the total value of bids received from a single participant.

[10] The rationale here is to avoid participants basing their bids on assumptions about others' behaviour.

[11] In the event that cash is lent instead, then the fee is the indexed bank rate in addition to the fees shown in the Figure 10; though such fees can vary at the bank's discretion.

> FIGURE 11: OVERVIEW OF THE FEES FOR THE DIFFERENT CATEGORIES OF COLLATERAL

Fees (basis points)			
Collateral% of Eligible Liabilities	**Level A**	**Level B**	**Level C**
0-5%	25	50	75
5-15%	Marginal cost rises linearly with quantity borrowed		
at 15%	75	125	300
>15%	Prices agreed bilaterally with the Bank of England		

Source: Bank of England, HSBC

Contingent term repo facility (CTRF)

The CTRF is a contingency liquidity facility that the BoE can activate in response to actual or prospective exceptional market-wide stress to undertake operations against the full range of eligible collateral (Levels A, B, C). This includes own-name covered bonds. Collateral is expected to be pre-positioned prior to an operation.

Funding for lending scheme (FLS)

The FLS was launched in July 2012 and is intended to encourage banks and building societies to increase their lending to UK households and corporates. Participants can borrow UK Treasury Bills against all collateral eligible under the DWF (i.e. Levels A, B & C). Both the fee and the amount participants can borrow will depend on their lending growth. The drawdown period started in August 2012 and was extended three times until January 2016. As part of this extension (in April 2013) the FLS was also expanded to count lending by certain non-bank providers of credit to the UK real economy. On 31 January 2014, the first phase of the FLS ended. Since then, household lending no longer generates any additional borrowing allowances.

> FIGURE 12: SUMMARY OF THE BOE'S MONETARY OPERATIONS

	Operational Standing Facilities	Indexed Long-term Repo	Discount Window Facility (DWF)	Funding for Lending (Extension)
What is the primary purpose of the operation?	Monetary policy implementation; Bilateral liquidity insurance to deal with frictional payment shocks	Liquidity insurance	Bilateral liquidity insurance	Boost lending to the UK real economy
What is being borrowed?	Deposit facility: n/a Lending facility: sterling cash	Sterling cash	Gilts	Treasury Bills
Eligible Collateral	Deposit facility: n/a Lending facility: Level A	Level A, B and C	Level A, B and C	Level A, B and C
Fee	Deposit facility: 0% Lending facility: 0.75%	Auction determined uniform spread indexed to Bank Rate	Fee dependant on size of drawing and collateral delivered	Flat rate of 0.25%
Maturity	Overnight	6 months	30 days	4 years
Frequency	Available daily	Typically monthly	Available daily	Available daily
Minimum bid/offer amount	n/a	£5mln	n/a	£1mln
Minimum bid/offer increment	n/a	£1mln	n/a	£0.1mln
Settlement date of the operation	T+0	T+2	T+0	T+0

Source: Bank of England, HSBC (as of July 2015)

Additional disclosure requirements for residential mortgage covered bonds

The Bank of England requires additional disclosure and transparency for RMBS and covered bonds backed by residential mortgages. The BoE requirements include anonymised loan level information for securities from these two asset classes. This must be provided for investors, potential investors and "certain other market professionals acting on their behalf." The information must be provided on at least a quarterly basis and within one month of an interest payment date.

Since December 2012, any covered bonds backed by mortgages which do not fulfil the criteria became ineligible for use in any of the Bank of England's monetary policy operations[12].

Loan-level reporting also includes "the requirement for credit bureau score data" to be made available. This needs to be provided within a three-month period of the transaction's origination and must be updated on a quarterly basis to enhance comparability between the various providers. The banks must make the information available on a 'comply or explain' basis. Where issuers are not able to fill-in certain data fields, this will not render a transaction ineligible automatically; instead the BoE will look at the rationale before determining eligibility and may choose to add additional haircuts. Nonetheless the BoE expects that ultimately all the mandatory information will need to be provided. These additional transparency requirements do not apply to public sector covered bonds.

IV. THE US: ELIGIBILITY CRITERIA FOR FEDERAL RESERVE OPERATIONS

The monetary policy operations of the Federal Reserve System work rather differently to those at the ECB or the Bank of England. The Federal Reserve Bank of New York implements monetary policy on behalf of the Federal Reserve System, as mandated by the Federal Open Market Committee (FOMC). Monetary policy is implemented through sales and purchases on the System Open Market Account (SOMA) at the Federal Reserve Bank of New York. This account is used both to maintain the overnight target rate for the federal funds rate (i.e. the US policy rate), as well as to undertake large scale asset purchase programmes decided upon by the FOMC. In particular, the three rounds of asset purchases (quantitative easing), the first consisting of Treasury securities, GSE debt and GSE-guaranteed MBS, the second solely of Treasuries and the third of agency MBSs, as well as the reinvestment of the coupons and principal payments received from the first round of QE, have all gone through this account. Currently, covered bonds are not eligible for any SOMA operations, which are restricted to US Treasury Bills, Notes and Bonds (including TIPS), Federal Agency securities[13] and MBS guaranteed by Fannie Mae, Freddie Mac and Ginnie Mae; all of which must be denominated in USD. None of the additional operations put in place during the first stage of the financial crisis are currently still in place, meaning the only significant other monetary operation is the discount window.

Covered bonds and the discount window

Only a very small list of covered bonds are eligible for the discount window, namely: **US covered bonds** and **AAA-rated German Jumbo Pfandbriefe**. In the case of the German Pfandbriefe, for the AAA requirement the lowest rating of S&P, Moody's and Fitch is relevant. A much softer rating restriction of simply being investment grade is applied to US covered bonds.

"In general, the Federal Reserve seeks to value securities collateral at a fair market value estimate. Margins are applied to the Federal Reserve's fair market value estimate and are designed to account for the risk characteristics of the pledged asset as well as the volatility of the value of the pledged asset over an estimated liquidation period. Securities are typically valued daily using prices supplied by external vendors. Eligible securities for which a price cannot readily be obtained will be assigned an internally modeled fair market value estimate based on comparable securities, and they will receive the lowest margin for that asset type."[14]

[12] With the exception of covered bonds already pledged within the Special Liquidity Scheme.

[13] Fannie Mae, Freddie Mac and Federal Home Loan Bank.

[14] Federal Reserve, Collateral FAQs as 29 June 2015.

The haircuts applied to the various assets eligible for use in the discount window are outlined below. Notably the foreign currencies eligible for the discount window are AUD, CAD, CHF, DKK, EUR, GBP, JPY and SEK.

The haircuts applied to covered bonds in the discount window operations are not very high and only marginally higher than those for Treasuries. For example, for tenors of 5-10 years, USD-denominated Pfandbriefe are subject to a haircut of only 4%, the same as stripped Treasury notes, supranational paper or GSE bonds. Nonetheless, the eligibility criteria for foreign-issued covered bonds are very strict, including solely German Pfandbriefe. All other covered bonds effectively appear to be treated in the same manner as unsecured bank debt, i.e. they are excluded from the discount window. Even other well-developed legislation-based covered bond types, such as Obligations Foncières or any of the various Nordic covered bonds have not been included.

> Figure 13: Overview of the margins for securities

		Margins for securities (by Maturity)		
Asset Class	**Asset Type**	**0-5 yrs**	**>5-10 yrs**	**>10 yrs**
US Treasuries	Bills/Notes/Bonds/TIPs	1.0	3.0	5.0
	STRIPs/Zero Coupon	2.0	4.0	8.0
GSEs	Bills/Notes/Bonds	2.0	4.0	6.0
	Zero Coupon	3.0	5.0	9.0
Foreign Government Agencies	AAA-BBB rated USD denominated	2.0	4.0	9.0
	AAA rated foreign denominated	6.0	7.0	9.0
Foreign Government, Foreign Government Guaranteed and Brady Bonds	AAA rated USD denominated	2.0	4.0	6.0
	AA-BBB rated USD denominated	3.0	5.0	8.0
	AAA-BBB foreign denominated	6.0	7.0	9.0
Supranationals	USD denominated	2.0	4.0	6.0
	AAA rated foreign denominated	6.0	7.0	9.0
	Zero Coupon	3.0	5.0	9.0
Corporate Bonds	AAA rated USD denominated	2.0	5.0	7.0
	AA-BBB rated USD denominated	4.0	6.0	8.0
	AAA rated foreign denominated	8.0	9.0	12.0
US Issued Covered Bonds	**AAA rated USD denominated**	**2.0**	**5.0**	**7.0**
	AA-BBB rated USD denominated	**4.0**	**6.0**	**8.0**
German Jumbo Pfandbriefe	**AAA rated USD denominated**	**2.0**	**4.0**	**6.0**
	AAA rated- foreign denominated	**6.0**	**7.0**	**8.0**
Asset Backed Securities	AAA rated	2.0	6.0	10.0
	AA-BBB rated	4.0	12.0	23.0
	CDOs- AAA rated	17.0	18.0	22.0
	CMBS- AAA rated	5.0	11.0	15.0
Agency Backed Mortgages	Pass-throughs	2.0	4.0	6.0
	CMOs	2.0	4.0	6.0
	Private-label CMOs- AAA rated	11.0	11.0	14.0
	Trust Preferred Securities	11.0	12.0	13.0
	Trust Deposit Facility- Term Deposits	0	n/a	n/a
	CDs, Bankers' Acceptances, CP, ABCP	2.0	n/a	n/a

Source: Fed (applicable as of 3 August 2015), HSBC

There is also a separate schedule for the percentage margin applied to loans, a number of categories of which are also eligible for the discount window facility. A further stipulation from the Fed is that obligations of the pledging depository institution (or of an affiliate) are not eligible collateral, ruling out own-name covered bonds.

V. SWITZERLAND: ELIGIBILITY CRITERIA FOR SWISS NATIONAL BANK (SNB) OPERATIONS

SNB monetary policy operations

Under its monetary policy framework, the Swiss National Bank (SNB) sets normally a 100 bps target range for the 3-month Swiss Franc LIBOR rate, with SNB targeting the middle of this range. Repos are its preferred open market operation used to achieve this target. These are conducted in parts by auctions, which are typically held every day, either in the form of a volume tender (fixed rate tender, which is the norm) or by variable rate tender. The SNB can also conduct bilateral repo operations to affect money market operations during the course of the day. All these repo transactions must be 100% collateralised. The terms are set on a daily basis and the maturity of the operations may vary from one day to twelve months. Hence, the SNB does not have distinct long-term repo operations in the same manner as the ECB or the BoE. Furthermore, the SNB can issue its own debt certificates (SNB Bills) as a means of absorbing liquidity through its money market operations when targeting the policy rate (or range). Such debt certificates can also be posted back to the SNB in the context of its repo operations (but cannot be used by banks to satisfy their minimum reserve requirements).

Under the SNB's typical volume tender, each counterparty offers for the amount of liquidity it is willing to provide for a given repo rate. If the total volume of offers exceeds the SNB's predetermined allotment volume, the SNB reduces the amounts offered proportionally. Each one of the counterparties receives the interest rate they bid. SNB Bill auctions are, as a rule, conducted in the form of a variable rate tender. Counterparties submit their offers comprising the amount of liquidity they are willing to provide and price at which they would do so. Counterparties can submit multiple bids, including at different interest rates. The SNB obtains liquidity from the participants that have made offers at or below the highest interest rate accepted by the SNB, paying the participants the interest rate stated in their offers.

In addition, the SNB provides standing facilities (a liquidity shortage facility and an intraday facility). For such facilities the SNB does not actively intervene in the market but rather "merely specifies the conditions at which counterparties can obtain liquidity[15]." Repo transactions within the context of standing facilities must cover at least 110% of the funds obtained. The remaining monetary policy operations used by the SNB are an intraday facility for banks, foreign exchange swaps with various central banks, as well as foreign exchange purchases (a means of intervening into foreign exchange markets affecting CHF). The SNB can also create, purchase or sell derivatives on receivables, securities, precious metals and currency pairs.

Covered bonds and other collateral eligible for SNB repo operations

For monetary policy operations the SNB has a standard collateral set which does not distinguish between collateral eligible for different operations. This is in line with the ECB but in contrast to the BoE policy. The SNB accepts a slightly wider set of collateral for its operations. In this sense, the SNB operates much more like the ECB than the Fed or BoE, with the latter restricting eligible assets of short-term monetary policy operations to only the highest-quality liquid government securities, with the exclusion of covered bonds.

Following the adoption of the Swiss Liquidity Ordinance which translates the LCR framework into Swiss law, the SNB has also redefined its collateral policy aligning it to the new liquidity provisions from 2015 onwards. The changes should ensure that all collateral eligible for SNB repos also fulfils the criteria for high-quality liquid assets (HQLA).

[15] Guidelines of Swiss National Bank (SNB) on Monetary Policy Instruments.

Only collateral included in the list of eligible collateral for SNB repos may be pledged in the repo transactions. In order to be eligible, the collateral assets must fulfil the following criteria:

> be issued by central banks, public sector entities, international or supranational institutions and private sector entities;

> securities issued by financial institutions are generally not eligible. However, covered bonds issued by financial institutions are eligible, provided the issuer is not a domestic financial institution or its foreign subsidiary. Moreover, securities issued by Pfandbriefbank schweizerischer Hypothekarinstitute AG and Pfandbriefzentrale der schweizerischen Kantonalbanken AG are also eligible;

> the issuer must be domiciled in Switzerland or in the European Economic Area (EEA), if the security is denominated in a foreign currency. Securities issued by international or supranational organisations may be admitted as eligible collateral even if the issuer is domiciled in a third country;

> have a fixed principal amount with an unconditional redemption;

> have a fixed rate, floating rate or zero coupon;

> have a minimum volume of CHF 100 mln for securities denominated in Swiss Francs or CHF 1 bn equivalent for securities denominated in foreign currencies;

> be traded on a recognised exchange or a representative market in Switzerland or EEA member state with price data published on a regular basis; and

> fulfil the country and issuer rating requirements (second-highest rating of the three rating agencies S&P, Moody's and Fitch is at least AA-/Aa3. If only one credit rating is available, this shall be used).

As such, covered bonds are eligible as long as they are not issued by a domestic Swiss bank (or a subsidiary abroad) with the exception of the Swiss Pfandbrief institutions. The criteria for the various classes of eligible assets are further split between foreign and Swiss Franc denominated criteria:

> Figure 14: Eligibility criteria for Swiss Franc and foreign currency securities

	Currency of Issue	Min. Rating of Creditor's Country of Domicile	Min. Rating of Security	Minimum issue size	Additional Criteria
Swiss Franc Securities	CHF	AA-/Aa3*	AA-/Aa3**	100 CHF m	Securities of foreign issuers must be listed on SIX Swiss Exchange
Foreign Currency Securities	EUR, USD, GBP, DKK, SEK, NOK	AA-/Aa3* (and must be domiciled in Switzerland or an EEA member state)	AA-/Aa3**	> CHF 1 bn equivalent (at time of issuance)	

* Securities of supranational organisations may be eligible irrespective of rating of country of domicile.

** Based on the second-highest rating; if only one credit rating is available, this shall be used. For securities issued by public sector entities and the Swiss Pfandbrief institutions which do not have a securities rating, the issuer rating may be used instead. Swiss public authorities, Swiss Pfandbrief institutions, the central issuing office of Swiss municipalities and Swiss issuers with explicit guarantee from Swiss Confederation are excluded from this requirement.

Source: SNB, HSBC

All securities contained in the list of collateral eligible for SNB repos form part of the SNB GC Basket and fulfil the criteria for high-quality liquid assets (HQLA) as defined in the Liquidity Ordinance. Based on their characteristics, the securities in this collective basket are assigned to additional baskets. The L1 Basket contains Swiss franc and foreign currency securities issued by, as a rule, central banks, public sector entities and multilateral development banks. The L2A Basket contains all other securities from the SNB GC Basket. In addition, Swiss franc securities are pooled in an L1 CHF Basket and an L2A CHF Basket. As is the case with all central banks, the SNB can decide on a case-by-case basis which securities are eligible for its repo operations. Its rules explicitly state that it "may reject the inclusion of securities or withdraw securities that were previously included in the list, without providing any justification."

Own-name covered bonds

The SNB publicly states that it does not accept counterparties' own securities or "those issued by persons or companies which, directly or indirectly, hold at least 20% of the capital or the voting rights in a counterparty or, conversely, in which the counterparty holds such rights". Nonetheless it explicitly states that "this 20% rule does not apply to participations in Swiss Pfandbrief institutions". Although it is not explicitly stated in official documents, SNB officials confirmed to us that own name covered bonds cannot be included within the boundaries set by the definition of eligible collateral.

VI. NORWAY: ELIGIBILITY CRITERIA FOR NORGES BANK OPERATIONS

Norges Bank monetary policy operations

The policy rate of Norges Bank is the sight deposit rate: the rate of interest banks receive on their overnight deposits (up to a quota) at Norges Bank. In October 2011, quotas were introduced defining the size of deposits banks could hold with Norges Bank on sight deposit rate terms. Banks' reserves with Norges Bank in excess of the quota were remunerated at a rate equal to the sight deposit rate minus 100bp, given banks a strong incentive to holding surplus reserves at the low reserve rate. Unlike other central banks, the key policy rate is not a target for overnight interest rates realised in money markets. Instead, the sight deposit rate forms a floor for very short-term money rates, whilst the overnight lending rate charged to banks for overnight loans (for "D-Loans", see below) is the other though less important interest rate, which forms a ceiling for very short-term money rates. This is typically set 100bp above the key policy rate. Norges Bank uses F-deposits (fixed-rate deposits) to remove unwanted liquidity from the system.

In terms of providing liquidity, Norges Bank provides intraday and overnight loans ("D-Loans"), which must be 100% collateralised. The bank also provides longer term liquidity through "F-loans" (fixed-rate loans), repurchase agreements and currency swaps. F-loans are ordinary fixed-rate loans with a given maturity provided against acceptable collateral "in the form of approved securities." The interest payable on such loans is determined by a multi-price ('American') auction. Just as in the case of the SNB, Norges Bank determines the total amount to be allotted in such an operation. Bids for the loans are ranked in decreasing order and allotments are made until the total amount is distributed, with all counterparties paying their respective bid price. Such loans also must be 100% collateralised.

Norges Bank has primarily granted "F-loans" to financial institutions rather than longer-term repo operations, following previously unsuccessful attempts to encourage the use of repo facilities in the past. F-loans are provided for a number of different maturities, much like the longer-term ECB-refinancing operations. Longer maturity F-loans were provided during the credit crunch; these even included the provision of a 3-year F-loan by the Norges Bank in February 2009.

The collateral set eligible for short-term "D-loans" at Norges Bank is identical to that for the longer-term "F-loans" as Norges Bank only uses one collateral set for all its operations. Its collateral rules group different securities into various liquidity categories, much like the ECB (see below for further detail).

Covered bonds and other collateral eligible for Norges Bank repo operations

In order to be eligible as collateral, securities must be listed on Norges Bank's website and have to fulfil the following eligibility criteria:

Type and Jurisdiction

> Bonds, notes and short-term paper issued from Norwegian and foreign issuers;

> Securities issued outside the EEA may be accepted provided that Norges Bank has legal confirmation that there are no problems associated with the realising of the collateral;

> Norwegian bond and money market funds (confined to investing in bonds, notes and short-term paper that are eligible under the current rules) are eligible as collateral provided that they are managed by a management company registered in Norway whose unit holdings are registered with the Norwegian Central Securities Depository (VPS) and that Norges Bank has access to price information from Oslo Børs Informasjon.

Credit rating

> Securities issued by foreign issuers and bonds, notes and short-term paper issued by Norwegian private entities are subject to credit rating requirements.

> Covered bonds issued under Norwegian law are exempt from the rating requirement if they are backed by domestic mortgage loans. For securities issued by Norwegian entities a credit rating of the issuer is sufficient.

> Norges Bank accepts credit ratings from S&P, Fitch and Moody's whereby a best rating approach is used, i.e. a satisfactory credit rating from just one of these three agencies is sufficient. The lowest acceptable credit rating for bonds with foreign issuers is A/A2, while the lowest acceptable credit rating for bonds issued by Norwegian issuers is BBB-/Baa3[16].

Listing

Securities issued by private entities are subject to listing requirements.

> Private securities pledged in the VPS must be listed on a stock exchange or other market place approved by Norges Bank.

> Securities pledged as collateral in another securities depository approved by Norges Bank must be listed on a stock exchange.

> The listing requirement does not apply to notes and short-term paper.

Requirements relating to minimum volume outstanding

Securities issued by private entities are subject to requirements relating to minimum volume outstanding:

> Securities in NOK must have a minimum outstanding volume of NOK 300 m, whilst securities in a foreign currency must have a minimum volume equivalent to EUR 100 m.

> If a security issued by a private entity is denominated in a foreign currency, a bank may not pledge more than 20% of the loan's outstanding volume to Norges Bank. The same applies to Asset-Backed Securities (ABS) denominated in NOK.

[16] The lowest acceptable credit rating for notes and short-term paper issued by foreign entities is A-1 from S&P or the equivalent rating from Fitch or Moody's, while the lowest acceptable credit rating for notes and short-term paper from Norwegian issuers is A-3 from S&P or the equivalent rating from Fitch or Moody's.

Currency restrictions

- Securities shall be denominated in NOK, SEK, DKK, EUR, USD, GBP, JPY, AUD, NZD or CHF. For securities denominated in a currency other than NOK an additional haircut of 5% is applied.

Multilateral development banks, government-guaranteed and regional debt securities

- Norges Bank may, subject to an assessment, exempt securities with irrevocable and unconditional government guarantees from the listing and minimum outstanding volume requirements. Subject to an assessment, Norges Bank may also permit a bank to collateralise more than 20% of the outstanding volume of a security of this type.
- Subject to an assessment, Norges Bank may grant the equivalent exemption for securities issued by regional or local authorities or multilateral development banks, as well as for government-guaranteed securities. These securities must then have a risk weighting of 0% in accordance with the capital adequacy requirements.
- In the case of government-guaranteed securities and securities issued by regional or local authorities or multilateral development banks, Norges Bank may, subject to an assessment, accept a credit rating provided by the issuer or the government guarantor.

ABS and other restrictions

- Asset Backed Securities (ABS) must have a AAA credit rating from S&P, Fitch or Moody's at the time of collateralisation and must be assessed by Norges Bank as what are termed "true sale" ABSs and must not be secured on commercial property loans.
- Only the most senior tranche will be accepted as collateral and the borrower cannot pledge more than 20% of the volume outstanding of any deal.
- An ABS may be rejected if the pledging bank has close ties to the special purpose vehicle of an ABS (for example in the form of agreements on interest rate or currency swaps, lines of credit or the servicing of loans).
- Collateralised debt obligations (CDOs) are not eligible as collateral.
- Unsecured securities issued by banks and other financial institutions, or unsecured bonds issued by companies where banks or other financial institutions indirectly or directly own more than a third are not eligible. Securities that are directly or indirectly linked to credit derivatives and zero-coupon bonds with a residual maturity of more than 7 years are not eligible as collateral. Nor will instruments such as convertible bonds, inflation-linked bonds, inverse floating rate bonds, FRN Caps or subordinated loans be eligible.

Own-name covered bonds

A bank may pledge covered bonds and ABS as collateral even if the securities are issued by the bank itself or by an entity that is part of the same corporate group as the bank. Own-name covered bonds are subject to an additional haircut of 5%.

Haircuts

The haircuts applied to the market value of a security are set out by category below:

> Figure 15: Norges Bank haircuts by category and residual maturity (% of market value)

Liquidity Category	Liquidity Category I		Liquidity Category II		Liquidity Category III		Liquidity Category IV	
Eligible Collateral	> AAA rated Government Bonds > Money market and bond funds confined to investments in the above securities		> Government bonds rated AA+ to A > *Covered bonds rated AAA to AA-* > Norwegian local government paper > Foreign local government paper rated A or better > 0% RW paper > Government-guaranteed paper > AAA rated corporates		> *Covered bonds rated A+ to A* > Corporate bonds rated AA+ to A > Units in eligible money market and bond funds		> Norwegian *covered bonds* rated A- or lower and unrated > Norwegian corporate bonds rated A- to BBB-	
Maturity	Fixed	Floating	Fixed	Floating	Fixed	Floating	Fixed	Floating
0-1 year	1.0	1.0	3.0	3.0	4.0	4.0	8.0	8.0
1-3 years	3.0	1.0	5.0	4.0	6.0	5.0	11.0	10.0
3-7 years	5.0	1.0	7.0	5.0	10.0	7.0	17.0	14.0
7+ years	7.0	1.0	10.0	6.0	13.0	9.0	22.0	17.0

Source: HSBC, Norges Bank

Notes: Securities in foreign currencies and own-name covered bonds are subject to a further 5% haircut. ABS are subject to a 15% haircut, regardless of maturity. Additional haircuts apply on FRNs if no price information is available.

Access to Norges Bank lending facilities by covered bond mortgage companies

In a statement published in May 2013, Norges Bank argues that "covered bond mortgage companies should not be given general access to the central bank lending facility" since "the granting of liquidity loans is expressly restricted to commercial banks and savings banks." It has to be noted however that "Norges Bank's ability to extend liquidity support to financial institutions in extraordinary cases is not limited by whether the institution has ordinary access to the lending facilities."

VII. AUSTRALIA: ELIGIBILITY CRITERIA FOR RESERVE BANK OF AUSTRALIA (RBA) OPERATIONS

The Reserve Bank of Australia (RBA) expresses its desired stance on monetary policy through an operating target for the cash rate, the money market rate on overnight interbank funds. The RBA targets this through its short-term open-market operations ("domestic market operations"). The same collateral set is also applicable to the longer-term operations provided.

When the RBA buys securities under repurchase agreement it does so in two broad classes of securities: government-related securities and private securities. Since the mid-1990s, the RBA has gradually widened the range of highly-rated securities that it is prepared to accept in response to the decline in available government debt and taking into account the changing structure of financial markets.

Covered bonds and RBA eligible securities for reverse repos

In order to be considered as eligible by the RBA, all securities, including covered bonds, must fulfil the following criteria:

> **Currency**: The security is denominated in Australian dollars and traded in Austraclear. The RBA will not accept securities that trade as Euro-entitlements.

> **Rating**: The lowest credit rating assigned to a security or its issuer by any of the major rating agencies will be used to assess eligibility and eventual haircut. For covered bonds only security ratings are considered as long as at least two ratings are available. Otherwise the minimum issuer ratings will be considered.

> **Structured bonds**: "Highly structured" securities are not eligible.

> **Own name bonds**: "Unless otherwise advised" securities issued by the bank itself or related entities are not eligible. A related party is deemed to be an institution that has a significant relationship to the credit quality of the security, including members of the same group and where one entity owns more than 15% of another. The list of eligible securities denotes the related parties for specific securities or programmes. This 'related party exemption' also applies to covered bonds and, as such, "own name covered bonds" are not eligible for RBA repo operations.

The current set of eligible securities and the respective minimum rating requirements are given below:

> FIGURE 16: ELIGIBLE SECURITIES AND MINIMUM RATING REQUIREMENTS

	Minimum Rating
General Collateral	
Commonwealth Government Securities	no minimum rating required
Semi-governments Securities	no minimum rating required
Issues by Supranationals and Foreign Governments	AAA*
Securities with an Australian Government Guarantee	no minimum rating required
Securities with a Foreign Sovereign Government Guarantee	AAA*
Private Securities	
Securities (including Covered Bonds) issued by authorised deposit-taking institutions (ADIs)	
Residual maturity of 1Y or less	Any public rating
Residual maturity > 1Y	BBB+
Asset Backed Securities	
Standard	A-1 or AAA
Other	A-1 or AAA
Other Private Securities	A-1 or AAA

* Minimum rating requirement waived for securities issued and/or guaranteed by the New Zealand government

Source: RBA, HSBC

These include covered bonds denominated in AUD which have to be issued in the Kangaroo market (i.e. onshore) to be eligible for Repo transactions with the RBA. The RBA is willing to accept "other AAA assets" which include covered bonds, as well as senior unsecured bank debt as long as it is rated AAA and denominated in AUD. The RBA accepts both legislative and structured covered bonds. As is the case with all central banks, the RBA retains the right to reject any particular security or securities from any issuer and specifically states that it will not accept "highly structured" securities. This does not apply to covered bonds, but to CDOs or similar structures.

Figure 17 below shows the margin ratios used by the RBA to discount the market value of securities purchased under reverse repos. They are applied according to the following formula:

purchase price = market value / (1 + margin / 100)

> Figure 17: Margin ratios of securities purchased under reverse repos

	Minimum Rating	Margins			
		0-1 years	1-5 years	5-10 years	>10 years
Government-related Securities					
Commonwealth Government Securities	n/a	1	2	2	2
Semi-Government Securities	n/a	1	2	2	2
Securities Issued by Supranationals & Foreign Governments	AAA	2	3	4	4
Securities with an Australian Government Guarantee	n/a	2	3	4	4
Securities with a Foreign Government Guarantee	AAA	2	3	4	4
Private Securities					
ADI-issued Securities including Australian Covered Bonds	AAA	6	7	8	10
	AA–	10	12	14	16
	A–	12	14	16	18
	BBB+	15	17	20	23
	Other rated	20	n/a	n/a	n/a
Asset-backed Securities					
> Standard	A-1 or AAA	10	10	10	10
> Other	A-1 or AAA	15-20	15-20	15-20	15-20
Other Private Securities	A-1 or AAA	6	7	8	10

Source: RBA, HSBC

VIII. NEW ZEALAND: ELIGIBILITY CRITERIA FOR RESERVE BANK OF NEW ZEALAND (RBNZ) OPERATIONS

RBNZ monetary policy operations

Since March 1999 the RBNZ has implemented monetary policy by setting the Official Cash Rate (OCR), which is reviewed eight times a year. The monetary operations of New Zealand are composed of (a) Liquidity Operations, (b) Standing Facilities and (c) Other Domestic Operations. The Open Market Operations (OMO) of the Reserve Bank of New Zealand (RBNZ), including *overnight repo transactions* and issuance of RBNZ bills (to remove unwanted liquidity) fall within the "Liquidity Operations", as do FX Swaps and Basis Swaps operations. The Standing facilities are made up of the Overnight Reverse Repo Facility and a Bond Lending Facility. Finally "Other Domestic Operations" consist of the repurchase or swapping of New Zealand government securities.

The following securities are eligible for the RBNZ's overnight repo transactions within the Liquidity Operations and the Bond Lending Facilities (part of the Standing facilities):

> New Zealand Government Treasury bills;

> New Zealand Government bonds;

> New Zealand Government inflation-indexed bonds; and

> Other (non-New Zealand Government Securities) as approved by the RBNZ.

Covered bonds fall within this final definition, as long as they comply with the eligibility criteria. These are set out in the section below. Covered bonds are not eligible for other RBNZ monetary operations. The eligibility of securities for the 'Overnight Reverse Repo' under the RBNZ Standing Facilities is restricted solely to New Zealand Government bonds, Treasury bills and RBNZ bills. For the "Other Domestic Operations", the RBNZ from time to time offers to either repurchase and/or swap New Zealand Government securities. Purchases may be for the RBNZ's own account or on behalf of the Crown.

Covered bond eligibility for RBNZ operations

As explained above, covered bonds are eligible for the RBNZ's overnight repo transactions within the Liquidity Operations and the Bond Lending Facilities, as long as they fit the following criteria:

Rating

> Issues are rated AAA by at least two acceptable rating agencies. In case of more than two issue ratings, at least two agencies must rate the issue AAA, and no rating should be lower than AA+.

> The issuer has a credit rating from at least two acceptable rating agencies.

Cover pool

> The cover pool must be comprised of New Zealand originated first registered mortgages on New Zealand residential properties.

> The mortgage collateral is owned by a special purpose vehicle (SPV) that is bankruptcy remote from the originator.

> The loan-to-value ratio for each individual mortgage does not exceed 80%.

> Mortgages with loan to value ratios that exceed the 80% level will be removed from the cover pool and replaced with qualifying mortgages.

> Only loans that are performing have been included in the pool (non-performing loans are defined as those that are 90 days or more past due).

> "Asset monitors" independent from the trustee and the originator verify calculations relating to asset coverage tests and any other key ratios and provide these, and any other relevant reports, to the RBNZ on a regular basis.

Price sources

> Covered bond pricing is available on at least 80% of days via the NZFMA's NZ Credit Market Daily Pricing Service. Pricing is available at all month-ends.

Currency

> Issues are denominated in New Zealand dollars (NZD) only.

Settlement

> Covered bonds are lodged and settled in NZClear. Eligibility criteria for lodgement into NZClear include having a suitable registrar and paying agent.

Own-name bonds

> Covered bonds are repo-eligible on a two-name basis only, thus removing the possibility of issuers posting 'own-name' covered bonds to the RBNZ.

Of course, as is the case for all central banks, the RBNZ reserves the right to refuse an asset for any reason and is not required to disclose such reasons. In particular, "it should be noted that if the credit rating of the issue falls below the Reserve Bank's threshold, then the issue will cease to be eligible in the Reserve Banks' operations."

Thus, the RBNZ applies relatively strict criteria in setting eligibility for covered bonds, in particular, the requirement that the cover pool can only comprise New Zealand originated first registered mortgages on New Zealand residential properties currently restricts the use of the repo facility to covered bonds issued by domestic banks (or New Zealand subsidiaries of foreign banks using domestic loans). Nonetheless, if a foreign issuer were to have eligible loans in the pool (and fulfil all the other criteria), their covered bonds could also be eligible. Covered bonds are also subject to the strict requirement of being NZD-denominated, consistently with the rules for all other securities; even bonds issued or guaranteed by foreign governments must be NZD-denominated. Therefore, US Treasuries or Bunds in their domestic currencies would technically not be eligible for the RBNZ's operations.

The full haircuts matrix can be found below. It shows that NZD Covered bonds receive relatively benign haircuts, in line with two-name basis NZD-denominated RMBS, but significantly better than single-name RMBS. Ultimately, the eligibility criteria for repo are strict but eligible covered bonds receive a highly favourable treatment.

> Figure 18: Haircut matrix

Eligible Security	**Minimum Rating**	**Haircut**		
		0 ≤ 1 yr	**1 – 5 yrs**	**≥ 5 yrs**
NZ Government & RBNZ				
Treasury Bills	AA+	1%	2%	3%
Bonds				
Inflation-linked Bonds				
RBNZ Bills	n/a	1%	2%	n/a
Acceptable Kauri issues (NZD)				
Liquidity Category 1 Country*	AAA	3%	4%	5%
	AA- to AA+	6%	7%	8%
Liquidity Category 2 Country**	AAA	4%	5%	6%
	AA- to AA+	7%	8%	9%
Bank Securities (NZD)				
Bank bonds – NZ Registered Banks only	AAA	5%	6%	8%
	AA- to AA+	8%	9%	10%
	A- to A+	10%	12%	15%
	BBB- to BBB+	15%	17%	20%
NZ Registered Bank RCD's	A-1 and above	10%	n/a	n/a
	A-2	20%	n/a	n/a
Local Authorities (NZD)				
Bonds	AAA	3%	4%	5%
	AA- to AA+	6%	7%	8%
	A- to A+	10%	12%	15%
	BBB- to BBB+	15%	17%	20%
CP	A-1 and above	6%	n/a	n/a
	A-2	15%	n/a	n/a

Eligible Security	Minimum Rating	Haircut		
		0 ≤ 1 yr	1 – 5 yrs	≥ 5 yrs
State-Owned Enterprises (NZD)				
Bonds	AAA	5%	6%	8%
	AA- to AA+	8%	9%	10%
	A- to A+	10%	12%	15%
	BBB- to BBB+	15%	17%	20%
CP	A-1 and above	10%	n/a	n/a
	A-2	20%	n/a	n/a
Corporate Securities (NZD)				
Bonds	AAA	5%	6%	8%
	AA- to AA+	8%	9%	10%
	A- to A+	10%	12%	15%
	BBB- to BBB+	15%	17%	20%
CP	A-1 and above	10%	n/a	n/a
	A-2	20%	n/a	n/a
Securities issued/guaranteed by Foreign governments				
NZD Denominated	AA+	6%	7%	8%
	A-1+			

Source: RBNZ, HSBC

* Liquidity Category 1: Austria, Australia, Belgium, Canada, Denmark, Finland, France, Germany, Italy, Japan, Luxembourg, Netherlands, Norway, Singapore, Sweden, Switzerland, United Kingdom and United States;

** Liquidity Category 2: Czech Republic, Hong Kong, Ireland, Malta, Spain, South Korea.

Eligible Security	Minimum Rating	Haircut	
		< 3 years	≥ 3 years
Asset Backed Securities			
Bonds	AAA	10%	15%
CP	A-1+	10%	n/a
RMBS (NZD- on a single name basis)			
Bonds	AAA	19%	19%
CP			
RMBS (NZD- on a two name basis)			
Bonds	AAA	5%	8%
CP			
Covered Bonds (NZD)			
Bonds	AAA	5%	8%

Source: RBNZ, HSBC

IX. CANADA: ELIGIBILITY CRITERIA FOR BANK OF CANADA MARKET OPERATIONS

The Bank of Canada uses a number of permanent facilities to conduct market operations:

> **SPRA/SRAs**: The Bank conducts Special Purchase and Resale Agreements (SPRAs) and Sale and Repurchase Agreements (SRAs) to implement its monetary policy framework in the Large Value Transfer System

(LVTS) environment. SPRAs and SRAs are used to reinforce the target overnight rate at the mid-point of the operating band.

- **Overnight Standing Purchase and Resale Agreement**: The Bank makes this standing facility available to Primary Dealers on an overnight basis at the upper limit of the operating band (Bank Rate).
- **Term Repo for Balance Sheet Management Purposes**: The Bank may acquire assets temporarily in the secondary market to manage short-term changes in the Bank's balance sheet, which is typically due to seasonal fluctuations in the demand for bank notes.
- **Securities Lending Program**: The Bank supports the liquidity of Government of Canada securities by providing a secondary and temporary source of securities to the market through a tender process for a term of one business day.
- **Standing Liquidity Facility**: The Bank of Canada provides Large Value Transfer System (LVTS) advances, which are collateralised overnight loans to direct participants in the LVTS. The same assets eligible for the Bank's Standing Liquidity Facility (SLF) are also eligible to obtain intraday liquidity for participants in the LVTS.
- **Bank of Canada Margin Call Practice for Domestic Market Operations**: For transactions outstanding against securities purchased or sold under a term purchase and resale agreement, the Bank values the securities daily, and compares that value to the contract valuation in order to ensure the Bank is adequately protected. The Bank may initiate a margin call, requesting the counterparty to deliver additional securities to cover any shortfall.

The Bank of Canada provides access to liquidity through its Standing Liquidity Facility (SLF), to institutions participating directly in the Large Value Transfer System (LVTS). Under the provisions of the Bank of Canada Act, the Bank's LVTS advances (the overdraft loans) are required to be made on a secured basis. The collateral used to secure these loans must be acceptable to the Bank of Canada, and an appropriate margin is applied. Notwithstanding the eligibility criteria listed below, the Bank of Canada retains the right of refusal for any asset or programme.

In December 2012, the Bank of Canada added Canadian covered bonds as eligible assets to the list of collateral that can be pledged under its Standing Liquidity Facility. The covered bonds have to fulfil the following criteria and conditions:

- Only covered bonds from programmes that are registered with the Covered Bond Registrar (CMHC) and are compliant with the federal legislative framework for covered bonds are eligible, i.e. Canadian Registered Covered Bonds.
- The *issuer* must have a minimum of two credit ratings from two major credit rating agencies, the second highest of which is at least A(low) by DBRS, A- by Fitch or S&P, or A3 by Moody's.
- Eligibility is restricted to covered bonds **denominated in Canadian Dollars**. This requirement is not limited to covered bonds but is applicable to all asset classes with the exception of US Treasuries denominated in US dollars.
- Covered bonds are subject to a 5% issuer concentration limit.
- No more than 20% of an institution's pledged collateral may be comprised of municipal government or private sector securities including covered bonds. Securities issued by other LVTS participants (also including covered bonds) are subject to a 10% limit.
- Banks cannot submit their own covered bonds as collateral.
- Haircuts will be based on the second-highest issuer credit rating.

> Figure 19: Haircuts for various asset classes and maturity brackets

Collateral type	up to 3 months	>3-12 months	>1-3 years	>3-5 years	>5-10 years	>10-35 years	>35 years
Securities issued by the Government of Canada	0.25%	0.5%	1.0%	1.5%	2.0%	3.0%	3.5%
Government of Canada – stripped coupons and residuals	0.25%	0.5%	1.0%	1.5%	2.0%	4.0%	11.5%
Securities guaranteed by the Government of Canada (including Canada Mortgage Bonds and NHA mortgage-backed securities)	0.5%	1.0%	1.5%	2.0%	2.5%	4.0%	4.5%
Government of Canada guaranteed – stripped coupons and residuals	0.5%	1.0%	1.5%	2.5%	4.0%	5.5%	13.0%
Securities issued by a provincial government	1.0%	1.5%	2.0%	2.5%	3.0%	4.0%	6.0%
Provincial government – stripped coupons and residuals	1.0%	1.5%	2.0%	3.0%	4.5%	6.0%	17.0%
Securities guaranteed by a provincial government	1.0%	2.0%	2.5%	3.0%	3.5%	4.5%	6.5%
Provincial government guaranteed – stripped coupons and residuals	1.0%	2.0%	2.5%	3.5%	5.0%	6.5%	17.5%
Securities issued by a municipal government	1.25	2.5%	3.0%	3.5%	4.0%	5.0%	5.5%
Bankers' acceptances, promissory notes, commercial paper, including those of foreign	1.5%	3.0%					
Term Asset-backed securities	3.75%	7.5%	8.0%	9.0%	12.0%	15.0%	17.0%
Asset-backed CP	3.75%	7.5%					
Covered bonds	2.0%	3.0%	3.5%	4.0%	6.5%	8.5%	9.0%
Corporate and foreign-issuer bonds	2.0%	3.0%	3.5%	4.0%	6.5%	8.5%	9.0%
Securities issued by the US Treasury*	1.0%	1.0%	1.0%	1.5%	3.0%	5.0%	

Source: Bank of Canada, HSBC

Notes: Non-mortgage loan portfolio: The Bank will provide a collateral-to-portfolio value of 60%; i.e. 60% of the reported value of the loan portfolio, implying a haircut of 40%.

* An additional 4% will be added to the margin requirements for securities issued by the US Treasury to account for foreign exchange risk.

X. COVERED BONDS AND REPOS: CONCLUSION

The comparison of the various treatments of covered bonds by some of the major central banks underlines the special status of covered bonds. In our opinion, this is driven by the macro-economic benefits of covered bonds through the provision of cheap residential (and commercial) mortgages and by giving banks a stable and relatively low-cost additional funding channel. However, there is no uniform approach and stances towards covered bonds by the various central banks differ considerably. Broadly speaking, covered bonds receive more favourable treatment in those countries where they play a more pivotal role in the funding of the domestic banking sector. This applies primarily in terms of eligibility of covered bonds as collateral for repo operations, but also in terms of the haircuts.

2.4 COVERED BONDS VS. OTHER ASSET CLASSES

By Florian Eichert, Crédit Agricole CIB & Chairman of the ECBC Statistics & Data Working Group,
Frank Will, HSBC & Chairman of the ECBC EU Legislation Working Group and Sebastian von Koss, HSBC

I. INTRODUCTION

In the past, a traditional ranking of bond spreads would have always had sovereign spreads trade the tightest followed by sub-sovereigns and agencies, and then covered bonds followed by senior unsecured debt. However, with the financial crisis and the subsequent sovereign debt crisis and more recently quantitative easing (QE) programmes by the Eurosystem, this ranking as well as the differences between these products has been profoundly shaken up.

Instead of trading with a significant pick-up compared to the respective sovereign, covered bonds in a number of countries represent the tightest product these days sometimes trading more than 100bp inside their respective sovereign debt. Senior unsecured debt on the other hand widened to levels vs. covered bonds well in excess of their pre-crisis levels only to come back to trade even inside covered bonds in some cases. And despite the introduction of the Bank Recovery and Resolution Directive (BRRD) the differences have yet to materially go wider.

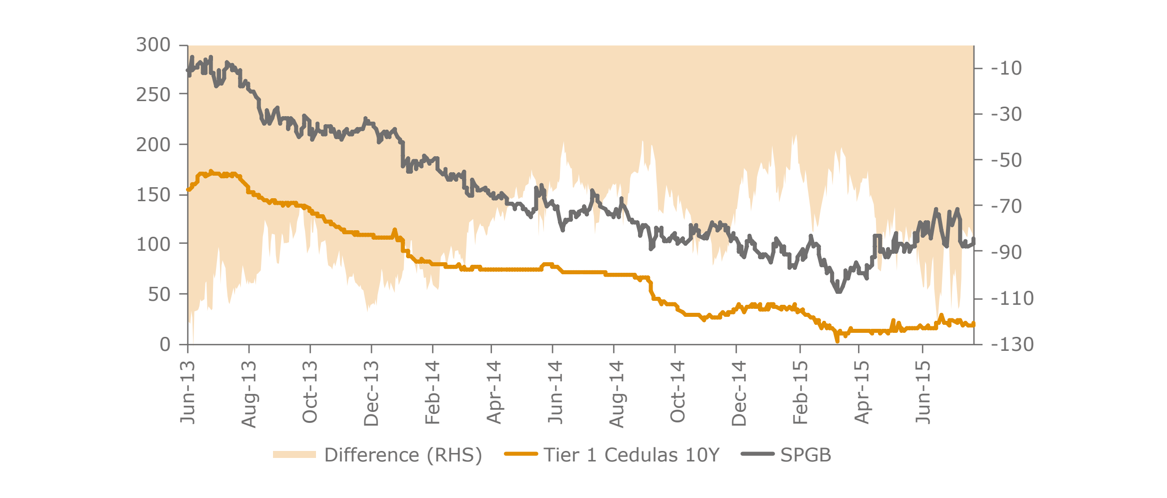
Last but not least and most recently, by including covered bonds in the first round of QE at the end of 2014 and only adding sovereigns, agencies and supranationals to the second round in 2015, the QE programmes of the Eurosystem have had a profound impact on the relationship of these sectors.

In this article we will take a look at how spreads have evolved between these products. We will assess what the rationale is for the differences and show how investors deal with the situation and why they buy at the levels they buy.

II. SPREAD OVERVIEW COVERED BONDS VS. SOVEREIGN DEBT AND SENIOR UNSECURED

Spreads between covered bonds and sovereign / agency / supra debt have been driven to a large extent by the QE programmes of the Eurosystem. When the first round of QE started in October 2014, the ECB only included covered bonds and ABS in the scope of eligible purchases. This led to a substantial tightening of spreads between covered bonds and public sector debt up until mid-January 2015. When the Eurosystem finally announced the expansion of QE to public sector debt, the differences widened again until March 2015. The substantial rates volatility in April / May 2015 then drove them to historic tight levels again.

> FIGURE 1: AVERAGE ASSET SWAP SPREADS 10Y SPANISH COVERED AND SOVEREIGN BONDS BP



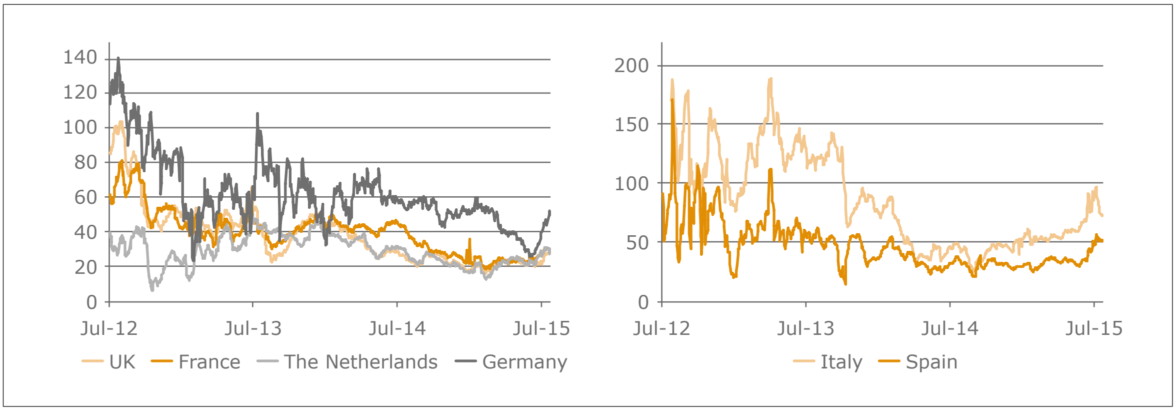
Sources: Bloomberg, Crédit Agricole CIB

Bank treasuries generally have a broad range of funding channels available including deposits, covered bonds, securitisation and unsecured funding. All of these various funding tools have their pros and cons from the issuer perspective. Senior unsecured funding is probably the most flexible form as it does not restrict the composition of the asset side. Covered bonds, on the other hand, require the issuers to maintain a cover pool of high quality assets backing the bonds. Moreover, regulatory rules and rating agencies often require that the mismatch between the cover assets and outstanding covered bonds is limited and that the covered bond issuer holds a certain amount of over-collateralisation (OC). In particular, the rating agencies often demand high OC level going well beyond the legal requirements.

From an investor's perspective, the secured character of covered bonds combined with their favourable regulatory treatment (low risk-weights, exemption from bail-in under BRRD, LCR-eligibility, etc.) make them an attractive investment usually reflected in significantly lower spread levels than senior unsecured debt.

However, over the last few years the spread differentials between senior unsecured bank debt and covered bonds have remained relatively low. Even the rise in overall yield levels since April 2015 has not triggered a widening of the spread differentials. It seems that, in this low-yield environment, investors in search of yield are inclined to accept the higher risk of unsecured paper in return for a few more basis points; this is particularly true for shorter-dated senior unsecured paper and for bonds issued by strong institutions, where the downside risks are often regarded as being smaller. In Figures 2 and 3 below, we compare individual bond pairs with 2017 maturity, allowing a maximum maturity mismatch of six months within each pair.

> Figure 2: Senior unsecured minus covered bond yields by country for core- (left) and periphery countries (right), 2017 maturities



Source: Bloomberg, HSBC

The comparison of individual bond pairs shows two things. First, sensitivity to changes in the overall yield levels of the "senior unsecured vs covered bond yield" increases sharply with rising maturities, even if the issuers are of similar risk. Second, while this recent yield move is often significant in relative terms – in many cases the spread between senior unsecured and covered bonds doubled in less than three months – the current spread differentials are still at low levels compared to mid-2012 and early 2013.

Unsurprisingly, bank treasuries are taking advantage of this demand pattern, and currently prefer unsecured bank debt as a funding instrument over covered bonds. From an issuers perspective the rationale behind this is simple. Despite the lower coupon, covered bonds cause higher administrative costs (e.g. cover pool administrator) and limit the flexibility regarding the assets in the pool compared to senior unsecured bonds. If the spread between both asset classes is lower than the difference in administrative costs and the loss of flexibility, it simply is cheaper to issue senior unsecured debt. This might be one of the reasons for the negative covered bond net supply we saw in 2014 and so far in 2015, despite the additional demand from the ECB covered bond purchase programme. Though low overall funding needs at the banks have probably also played a role.

These tendencies of the last 18 months are in contrast to the regulatory developments over the same period. Covered bonds are supported by the new bail-in regulation as well as amendments to the rating methods used by the major rating agencies, which reflect the impact of the Bank Recovery and Resolution Directive (BRRD) (see separate section below). This year's rating actions especially undertaken by Moody's and Fitch point to a wider gap between both asset classes. However, we believe these factors continue to have only a limited impact on spreads, as technicals (overall low supply volumes, low yield environment) will remain the dominant spread drivers. Moreover, even with the BRRD and Single Resolution Mechanism (SRM) in place, it will be quite rare to see senior bail-in – especially in the case of large, systemically important institutions.

Central bank haircuts

Before going into the fundamental factors driving each product pair (covered vs. senior and covered vs. sovereign debt), we want to provide a brief overview of how the various products are treated for repo purposes.

As part of its open market operations, the European Central Bank (ECB) has implemented risk-control measures to protect itself from potential collateral losses in case the underlying assets must be liquidated due to a counterparty's default. These measures encompass initial margins, valuation haircuts, variation margins, limits, additional guarantees and exclusions. The value of the underlying asset is calculated as the market value of the asset less a certain percentage ("valuation haircut").

> Figure 3: Eurosystem repo haircuts

	Liquidity categories								
	I		II		III		IV		V
AAA to A-	Government Bonds		Local & Regional Govt, Supras & Agencies, Jumbo Covered Bonds		Traditional Covered Bonds, Structured Covered Bonds, Multi-Issuer Covered Bonds, Corporate Bonds		Unsecured Bank Bonds		ABS
Residual maturity (years)	Fixed coupon	Zero coupon	Fixed coupon	Zero coupon	Fixed coupon	Zero coupon	Fixed coupon	Zero coupon	Fixed / Zero coupon
0-1	0.5	0.5	1.0	1.0	1.0	1.0	6.5	6.5	10.0
1-3	1.0	2.0	1.5	2.5	2.0	3.0	8.5	9.0	10.0
3-5	1.5	2.5	2.5	3.5	3.0	4.5	11.0	11.5	10.0
5-7	2.0	3.0	3.5	4.5	4.5	6.0	12.5	13.5	10.0
7-10	3.0	4.0	4.5	6.5	6.0	8.0	14.0	15.5	10.0
>10	5.0	7.0	8.0	10.5	9.0	13.0	17.0	22.5	10.0
Retained CB	**+13% (+5% for non marketable + 8% for retained)**								

BBB+ to BBB-									
Residual maturity (years)	Fixed coupon	Zero coupon	Fixed coupon	Zero coupon	Fixed coupon	Zero coupon	Fixed coupon	Zero coupon	Fixed / Zero coupon
0-1	6.0	6.0	7.0	7.0	8.0	8.0	13.0	13.0	22.0
1-3	7.0	8.0	10.0	14.5	15.0	16.5	24.5	26.5	22.0
3-5	9.0	10.0	15.5	20.5	22.5	25.0	32.5	36.5	22.0
5-7	10.0	11.5	16.0	22.0	26.0	30.0	36.0	40.0	22.0
7-10	11.5	13.0	18.5	27.5	27.0	32.5	37.0	42.5	22.0
>10	13.0	16.0	22.5	33.0	27.5	35.0	37.5	44.0	22.0
Retained CB	**+17% (+5% for non marketable + 12% for retained)**								

Sources: Eurosystem, CréditAgricole CIB

The ECB applies different valuation haircuts for covered bonds and senior unsecured debt as shown in the figure above. While covered bonds belong to liquidity categories II and III, unsecured bank bonds are in liquidity category IV with substantially higher haircuts. Moreover, covered bonds have been exempt from the ECB's close-link prohibition under which a bank cannot submit its own senior unsecured bonds as collateral. Own-name covered bonds are accepted, subject to additional haircuts.

When comparing covered bonds vs. sovereign debt on the other hand one can see that sovereign debt still gets the most favourable treatment by the Eurosystem. Covered bonds are not far behind though. For a 5Y AAA jumbo covered bond in category 2, the haircut differential is a mere 2% while for a covered bond from category 3 the difference is 2.5%.

For repo purposes we thus still have the old traditional ranking between asset classes. Sovereign debt is treated best, covered bonds follow closely behind and senior unsecured exposure has the highest haircuts and the most limitations (close link rule).

III. WHICH FUNDAMENTAL FACTORS DRIVE COVERED BONDS VS. SENIOR UNSECURED?

Comparing covered bonds and senior unsecured bank debt is ultimately a choice of where to invest within a bank's capital structure. Both asset classes are senior bank liabilities. Senior unsecured debt is structurally subordinate to covered bonds due to covered bond holders' preferential claim on the cover pool, on which senior unsecured creditors have a claim on only after covered bond holders and other preferred creditors have been fully repaid.

The relative value between both asset classes is driven by various aspects:

> **Probability of default**: Covered bonds are structured to survive an issuer event of default and not to accelerate automatically. As a result, the *conditional* probability of default (PD) of a covered bond (the product if the issuer's PD and the probability of payment interruptions on the covered bonds post issuer default) should typically be lower than the senior unsecured PD, which represents the cap for the covered bond PD. The strength of the covered bond framework plays a major role here. This includes provisions for an effective segregation of cover assets and privileged derivatives in an insolvency scenario as well as (structural) features to mitigate liquidity risks such as liquidity buffers or different repayment structures.

> **Recovery rate**: Different recovery rates are a major determinant between covered bonds and senior unsecured paper. In a default scenario, covered bond holders benefit from the double recourse to both the cover pool and to the issuing bank, ranking *pari-passu* with senior unsecured investors should the cover pool be insufficient for a full recovery. Senior secured issuance structurally subordinates senior unsecured creditors, reducing their recovery expectations. Not only the over-collateralisation (OC) ratio but also the quality of the collateral is a decisive factor for the expected recovery of covered bond holders relative to senior unsecured creditors. Normally high quality asserts form part of the covered pool. Hence a high OC and therefore a high asset encumbrance reduce both the quantity and the quality of the assets (directly) available to senior unsecured bondholders.

> **Bail-in risk**: Systemic support has been the main determinant for the very low default rates on senior unsecured bonds despite a number of bank failures that occurred during the financial crisis. However, bail-in risk has become a new factor to the relative value equation. While covered bonds have been generally exempt from bail-in under the European bank resolution framework, for example (with the exception of any under-collateralised part), senior unsecured creditors can be subject to bail-in under the BRRD before resolution funds are tapped or taxpayer money is injected.

> **Regulatory treatment**: Covered bonds are treated favourably to senior unsecured paper in a number of regulatory frameworks, such as the Capital Requirements Regulation (CRR) where lower risk-weights are assigned to covered bonds, the liquidity coverage framework where senior unsecured paper is not eligible while most covered bonds qualify as either Level 1B, 2A or 2B, and Solvency II where covered

bonds benefit from lower risk factors or the UCITS Directive allowing for higher investment limits in covered bonds. Unfavourable regulatory treatment can either exclude certain investor groups or lead to higher spreads being demanded as compensation for additional cost on the investment in senior unsecured bonds relative to covered bonds.

> **Central bank repo eligibility and haircuts**: For bank investors, central bank repo eligibility is an important factor when structuring their liquidity portfolios. If eligible, central banks apply higher haircuts to senior unsecured bank paper than covered bonds. Higher haircuts increase banks' funding costs as the haircut part of the bond posted as collateral needs to be funded using alternative sources.

> **Rating stability and differential**: Rating agencies used to link their rating on covered bonds to the issuer/senior unsecured rating. The senior unsecured rating was the floor for the covered bond rating, with the uplift depending on asset-liability mismatches, recovery rates, and legal and structural aspects. In light of the new BRRD, all major rating agencies came up with new frameworks partly decupling covered bond ratings from the issuer rating. In essence, the senior unsecured rating benefits less form government support, while the gap between covered bonds and the issuer rating widens. While even in the past covered bond ratings tended to be less volatile than senior unsecured bonds, this should be the case even more under the revised criteria. As most regulations as well as most central bank eligibility criteria contain rating references, the rating differential becomes even more relevant.

> Figure 4: Pros & cons of covered bonds vs. senior unsecured from an investor's point of view

Advantages of Covered Bonds	Advantages of Senior Unsecured Debt
> Double recourse to issuer and cover pool > Higher rating than unsecured debt > Lower risk weighting for CRR-eligible Covered Bonds bought by EEA banks > Favourable treatment under Solvency II > Generally better liquidity through larger issue size > Favourable repo treatment at ECB and other central banks > Most covered bonds are eligible as liquid assets under the CRR > No risk of bailing-in of the secured claim	> Higher yield (although "spread give up" is currently at low levels) > Often high turnover despite smaller sizes (due to lower portion of buy-and-hold investors)

Source: HSBC

1. Differences in regulatory treatment

Liquidity Coverage Ratio

The liquidity coverage ratio which was first introduced by the Basel Committee on Banking Supervision in December 2009 requires banks to hold a stock of unencumbered high quality liquid assets to meet 30 days cash outflows under an acute stress scenario. Meanwhile, the net stable funding ratio (NSFR) measures the amount of longer-term, stable sources of funding employed by a bank relative to the liquidity profiles of the assets and the potential for contingent calls on funding liquidity arising from off-balance sheet commitments and obligations.

While highly-rated covered bonds form part of the set of liquid assets, senior unsecured bank bonds do not qualify. Next to cash, deposits at the central bank, all types of bonds issued or guaranteed by EU Member States' central government, certain agency and supranational issues, Level 1 HQLAs (High Quality Liquid Assets) include covered bonds that meet certain conditions: They must being issued by an institution out of the European Economic Area, having a credit quality step 1 (i.e. a rating of AA- or better), a minimum size of EUR500m and a minimum over-collateralisation of 2%. Whilst other Level 1 assets are neither subject to liquidity buffer limits, nor to a haircut to their market value, Level 1 covered bonds will be subject to a 70% cap in the liquidity buffer and a 7% haircut.

Level 2A assets include regional governments, local authorities or PSE with a risk weight of 20% and covered bonds with a credit quality step 2 rating and non-EU covered bonds rated at credit quality step 1. Also corporate bonds with at least credit quality step 1, a minimum issue size of EUR250mn and maximum maturity of 10 years at the time of issuance are classified as Level 2A.

Level 2B incorporates high quality securitisations for RMBS, auto, SME and consumer loans and high quality covered bonds that do not meet the rating threshold of Level 1 and 2A. Shares meeting certain conditions and corporate bonds with at least credit quality step 3, a minimum issue size of EUR250mn and maximum maturity of 10 years at the time of issuance are accepted as Level 2B.

The classification of covered bonds as Level 1 and Level 2 is very positive. We expect that many European bank treasuries will use covered bonds in addition to sovereign, agency and supranational debt and will optimise their liquid asset portfolio under both liquidity and risk-return considerations. The spread impact on covered bonds, however, should at least in the short run be limited as spreads in this sector are already heavily compressed due to the CBPP3, negative net supply as well as the TLTROs. Moreover, the favourable treatment of covered bonds was well-flagged and should be largely priced-in.

Risk-weights

In times of rising minimum requirements for regulatory capital, risk-weights applied for the calculation of a bank's stock of risk-weighted assets have gained further importance. Regulatory capital is a bank's most expensive source of funding and bank investors are optimising their portfolios taking into account the capital consumption of their positions.

Bank investors based in the European Economic Area (EEA) can apply preferential risk-weights for covered bonds, fulfilling the criteria laid down in Article 129 CRR compared to senior unsecured bank bonds. A lower risk-weight means that banks have to hold less regulatory capital against a given position which benefits the average funding cost and thus the spread which is required. Covered bonds not fulfilling those criteria receive the same treatment as senior unsecured bonds. *Please refer to Article 2.2 of the Generic Section, for details on the determination of risk-weights for covered bonds*.

Bail-in

In the EU, the Bank Recovery and Resolution Directive (BRRD) was adopted in Q2 2014 together with the Single Resolution Mechanism (SRM). The BRRD defines the triggers for a resolution of a failing bank in the EU and provides the necessary tools while the SRM centralises the decision-making process for the large and cross-border banks in the Euro Area. At the heart of the BRRD lies the bail-in tool. The bail-in tool, which aims to ensure that shareholders, sub-debt and senior unsecured investors will bear the losses of a struggling bank rather than the taxpayers, will be available to EU governments from 1 January 2016. The possibilities for governments to support banks will be narrowed considerably and senior unsecured is at risk of burden-sharing after equity and sub debt.

Covered bonds have been excluded from the list of bail-in-able liabilities. Where appropriate, resolution authorities could exercise bail-in powers to a part of a secured liability that exceeds the value of the assets, i.e. any under-collateralised part or senior unsecured residual claim.

2. Ratings

New rating methodologies

Over the last 12-15 months, the major rating agencies have introduced new rating methodologies for covered bonds and have started adjusting their covered bond ratings in light of the new bank resolution regimes. Given the link between issuer ratings and covered bond ratings, the net effect of the introduction of the bail-in rules will have either a positive or a negative impact on the covered bond ratings depending on the individual issuer. On the one hand, covered bonds are explicitly exempted from bail-in and the recent changes of the rating methodologies by the agencies reflect the preferential treatment of covered bonds under the new resolution regimes. This positive effect could, on the other hand, be (more than) offset by issuer downgrades.

Over the past months, there have been numerous rating changes for covered bonds as well as for covered bond issuers. While in many cases the covered bond ratings were adjusted before the implementation of a new bank rating methodology, covered bond ratings had to undergo two rating impacts. So far, the overall rating impact for covered bonds was predominantly positive and in any event, the rating differential between both asset classes widened significantly. This further improves the rating advantage covered bonds have vs senior unsecured debt.

We view it as crucial that the starting point of the covered bond ratings is not the senior unsecured rating as the bailing-in of senior unsecured debt no longer automatically triggers an issuer default. The newly introduced resolution measures principally aim at maintaining a going-concern entity. The fact that covered bonds are exempted from bail-in measures means that a different starting point for the covered bond rating has to be used.

Structural subordination

Differences in recovery expectations are another main determinant of the relative value between covered bonds and senior unsecured. Against this backdrop, rising concerns from senior unsecured investors about structural subordination have been a factor supporting the covered bond market. The increased use of covered bond funding by banks over the last several years means that more assets were ring-fenced. As assets in the cover pool are not available to cover the claims of senior unsecured investors in case of issuer insolvency[1], market participants have started to worry about the growth in covered bond issuance and the subsequent reduction of assets available to unsecured investors in an insolvency scenario. This problem has been exacerbated by rating agencies' demands for higher over-collateralisation levels, which in most cases significantly exceed the legal over-collateralisation requirements and further reduce the amount of assets available for investors outside the cover pool.

While we understand the concerns in the market, we think asset encumbrance discussions often tend to overstate the problem arising from structural subordination through covered bonds while ignoring other sources of encumbrance (including *contingent* encumbrance when a bank's financial situation deteriorates) such as central bank repos/liquidity assistance as well as ignoring offsetting factors. The use of covered bonds usually results in lower funding costs for the banks and significantly broadens the investor base allowing issuers to tap rates investors such as central banks. In addition, it is a more stable funding base. Even if the unsecured market is closed for an issuer, the bank may still be able to access the wholesale markets by the means of covered bonds or, in a worst case scenario, it can retain the bonds to use them for repo transactions with central banks such as the ECB. Moreover, the potential issuance volume of covered bonds is not unlimited. The availability of eligible assets is a restricting factor for covered bond issuance, putting a cap on the actual issuance potential. Also the aforementioned requirements from rating agencies, of high over-collateralisation levels, further reduce the available headroom for covered bond issuance.

[1] If all the covered bonds of an insolvent issuer have been repaid and the claims of all covered bond investors have been satisfied, the remaining assets in the respective cover pool would generally be made available on a pro-rata basis to the senior unsecured investors. Moreover, in some jurisdictions, such as Germany, in case of issuer insolvency senior unsecured investors would have access to assets in the cover pool that are visibly not necessary to cover the outstanding covered bonds and related liabilities. Given the dynamic character of the market, a very high hurdle must be overcome in order for this process to trigger, and we would expect that only in very few, selected cases the insolvency administrator of the cover pool would agree to such a transfer.

Fitch's study on the use of covered bonds published in June 2014 showed that 70% of the covered bond issuers rated by Fitch have a cover pool encumbrance (defined as cover pool in % of adjusted total assets) of less than 20%. Only about 10% of the issuers have a cover pool encumbrance of more than 50%, most of which are specialised mortgage or public-sector subsidiaries of larger banking groups. On average, cover pool encumbrance has remained broadly stable from 2011 to 2013, averaging 10%, according to Fitch data.

Covered bonds are probably the most transparent but certainly not the only source of asset encumbrance. In order to allow for improved comparability, the EBA published guidelines on the disclosure of unencumbered and encumbered assets (as well as associated liabilities). These guidelines are intended as a first step towards a consistent and harmonised disclosure enhancing comparable information available to investors. Regulators and financial institutions "must make every effort to comply with the guidelines." The template includes a box where institutions are given the possibility to explain the importance of secured funding for their business model and elaborate on the evolution over time with a view to structural and cyclical factors influencing the funding mix. However, the guidelines have been modified to ensure that encumbrance to central banks and central bank liquidity assistance cannot be detected, taking into account concerns about "unwanted effects" such a level of disclosure might have on financial stability.

IV. WHICH FUNDAMENTAL FACTORS DRIVE COVERED BONDS VS. SOVEREIGN AND SUPRA/AGENCY DEBT…?

Despite the fact that covered bonds in a number of countries trade well inside their sovereign debt, sovereign risk does fundamentally impact covered bonds. In fact sovereign risk impacts covered bonds to at least some extent in all aspects of the product. The issuer, the cover pool and pool assets, liquidity and refinancing risk in the structure as well as ratings are all impacted by it.

> Issuers especially those with a strong domestic presence are directly impacted by a weakening sovereign. Their business prospects deteriorate as a weaker sovereign and a weaker economic situation go hand in hand. In addition to this, many bank treasuries hold substantial volumes of their own sovereign debt making them directly susceptible to widening sovereign spreads.

> Cover pool assets are impacted as well. Weaker economic growth usually means higher unemployment and thus higher NPL ratios. And if one were to spin this scenario all the way to a sovereign default, international demand for housing would most likely collapse with all consequences for house prices and LTVs.

> With very few exceptions, covered bonds are no pass-through securities. Bullet bonds refinance granular loan portfolios and there are mismatches that need to be refinanced via external liquidity. Should a sovereign run into trouble, issuers will find it harder and harder to refinance liquidity mismatches either via further issuance, third party liquidity lines or portfolio sales. Covered bond programmes backed by pools that might not even have any problems credit quality wise could thus be impacted negatively.

> For rating agencies sovereigns play a major role in rating covered bonds. They for example link issuer ratings to that of the sovereign unless an issuer has a substantial presence in other countries as well. They factor in sovereign bond spreads into their cash flow cover pool models thus driving up OC requirements in times of sovereign stress. And last but not least, Fitch, Moody's and S&P all operate with sovereign ceilings for structured finance instruments including covered bonds.

Bottom line is that sovereign risk does play too big of a factor in covered bond structures to just ignore it. Nonetheless there are reasons why in some cases covered bonds can very well trade inside their respective sovereign bond curves.

Being part of QE programmes and the respective weight the Eurosystem has in these markets

We have mentioned above that the QE programmes by the Eurosystem have played a major role in the evolution of the spreads of all affected markets. Beyond the short term trading view that has driven the affected markets tighter after the respective QE announcements, the longer term spread impact of QE strongly depends on the actual share the Eurosystem's acquires in these sectors. And while the short term reaction of the CBPP 3 and the PSPP has been similar (spreads went tighter), the longer term impact will be very different.

The ECB is buying around 10-12bn covered bonds per month for the CBPP 3 while at the same time purchasing around 45bn in eligible government, agency and supra debt for the PSPP.

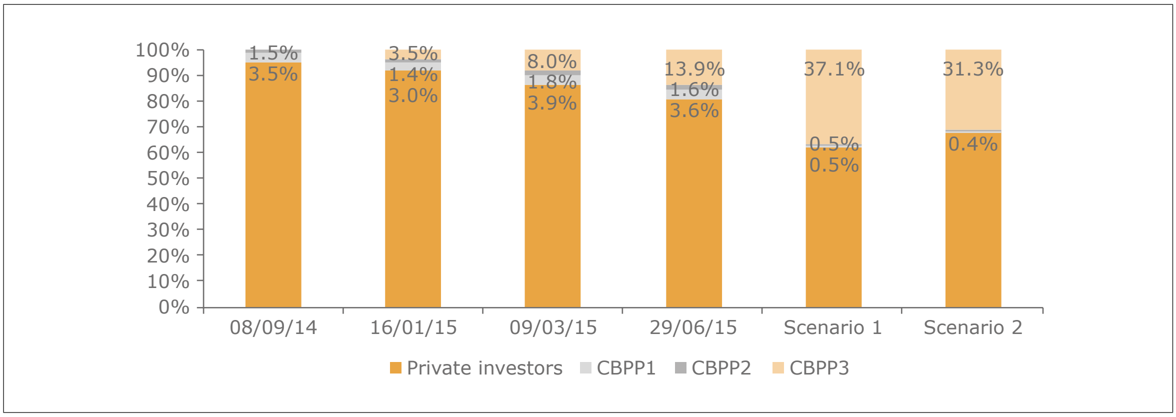
Despite the lower absolute volumes purchased in covered bonds, the distortive factor of the CBPP 3 is substantially higher than it is under the PSPP.

> By September next year, the Eurosystem will hold between 35% and 40% of the eligible covered bond universe.

> The only other market where QE can play a somewhat similar role is in debt issued by supranational issuers where the ECB could end up holding up to 20% of the eligible universe in case they do not change the 12% of the additional asset purchases target that is reserved for debt by these issuers.

> The QE impact on sovereign or agency markets is nowhere near as pronounced as it is for covered bonds. There is no quota for agency debt and considering the size of sovereign debt markets the purchases by the Eurosystem will probably lead to a market share in the mid-single digit territory.

> FIGURE 5: SHARE OF THE EUROSYSTEM'S PURCHASE PROGRAMMES IN THE OUTSTANDING ELIGIBLE COVERED BOND UNIVERSE (%)



Source: CréditAgricole CIB

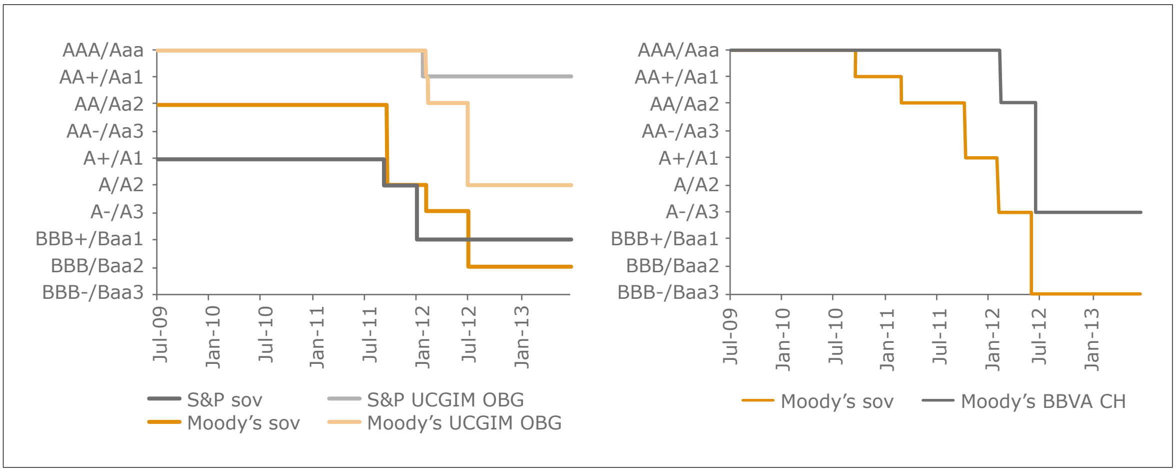
While not having anything to do with fundamental quality of covered bonds, the different shares the Eurosystem holds at the end of QE will continue to be a major spread driver of covered-government spreads. One of the most extreme cases would be Italy where the sovereign debt market is substantially larger than the OBG market. The share of the Italian central bank in the PSPP and CBPP 3 is however the same as it is based on the bank's share in the ECB's capital key. Consequently its weight in the Italian covered bond market is disproportionately higher than it is in BTP space. While Italy is probably an extreme case, a similar statement can be made for covered bonds in general – the CBPP 3 distorts the market much more than the PSPP.

Rating stability

Despite rating agencies factoring in sovereign ratings into covered bond ratings, they do allow for a certain rating uplift above the sovereign. The maximum uplift depends on the rating agency and collateral type but it can reach up to 6 notches in general with Moody's or 4 notches for mortgage backed covered bonds with S&P. Thanks to this uplift covered bond ratings do not react as fast as their respective sovereign ratings. Especially when sovereign ratings start to come under pressure, covered bonds often see their ratings remain stable. Only once the maximum uplift above the sovereign is used up do they start to move as well.

S&P's OBG ratings of Italian national champions for example are still rated 4 notches above the Italian sovereign while Moody's grants six notches of uplift. In addition, the OBG ratings have been much more stable historically than the Italian sovereign.

> FIGURE 6: COVERED BOND VS. SOVEREIGN BOND RATINGS



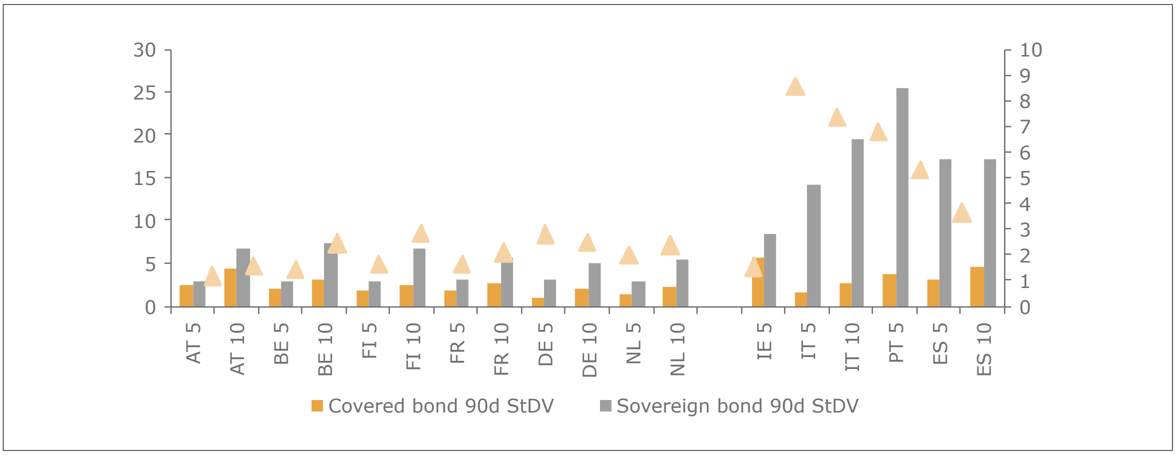
Sources: Bloomberg, CréditAgricole CIB

In Spain, the sovereign is rated Baa2 by Moody's while the Cedulas of at least the better issuers are by now back to Aa2. And in Portugal, investors that are prohibited from holding non-investment grade debt have Portuguese covered bonds as one alternative that can be rated as high as A1 with Moody's while the sovereign still has a Ba1 rating.

Spread stability

One of the main arguments pro covered bonds throughout the sovereign crisis or the more recent rates volatility in the first half of 2015 has been their spread stability. While even German Bunds experienced intra-day volatility of 20bp and more, covered bonds remained extremely stable. Looking at 90d standard deviation of ASW spreads shows that the covered bond volatility has been a fraction of their corresponding sovereign debt markets.

> FIGURE 7: COVERED BOND VS. SOVEREIGN BOND VOLATILITY (BP)



Source: CréditAgricole CIB

One of the reasons for this lagging of covered bonds is certainly the different investor base and less active trading in covered bonds. Buy and hold investors play a much more important role in covered bonds and the impact of the CBPP 3 is substantially higher than the PSPP in sovereign debt whereas trading accounts are more active in sovereign debt.

Spread volatility is less of a problem for long term buy and hold investors but certainly causes problems for asset managers valuing their funds' assets. It also causes problems for banks VAR calculations. While European banks don't have to hold capital for European sovereign debt, they do have to hold capital to cover the volatility of their trading assets. And the more volatile a certain asset is the more capital banks have to hold. Spread stability of covered bonds thus has a very feasible economic value and reduces the overall capital consumption difference to sovereign debt.

ECB repo efficiency

Bank investors are a major investor base in both sovereign debt as well as covered bonds. One of the main things bank treasuries focus on when investing is the repo efficiency of an investment. The lower the haircut and the less volatile price the better.

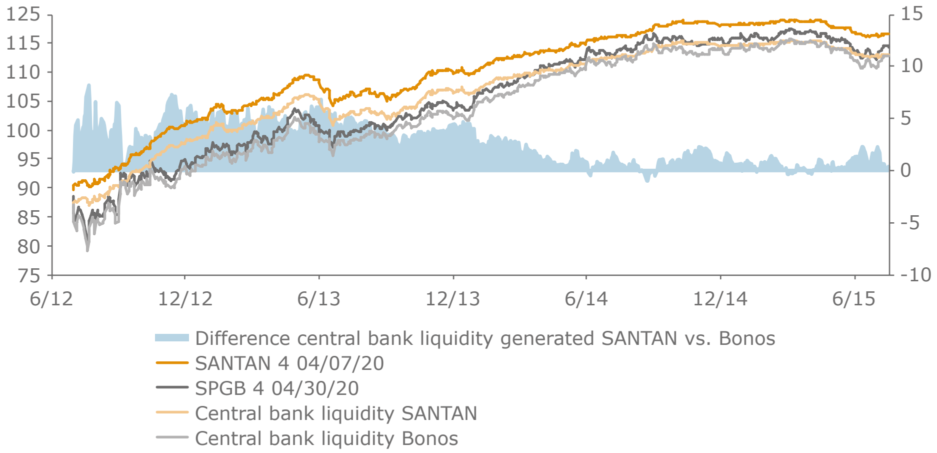
As mentioned above, repo haircuts for covered bonds are fairly similar to those of sovereign debt as long as both are rated at least A- by one rating agency (the best rating is relevant for this purpose). Currently most covered bonds in the market fall into the lower haircut table, even if in some cases they only benefit from this thanks to their DBRS rating.

If we look at two bonds with identical coupons and similar maturities, the one with the significantly tighter spread is trading at the higher price and thus generating more central bank liquidity (liquidity is measured based on market price minus haircut). When running this comparison between sovereign bonds and covered bonds, sovereign debt is the clear winner in virtually all core countries thanks to slightly lower haircuts but most of all lower spreads and higher prices.

However, in some peripheral countries, covered bonds have been able beat their sovereign pendants when it comes to ECB liquidity generated throughout the crisis. The liquidity advantage was also highest whenever the degree of stress in the market was highest, which is exactly when banks require stable central bank liquidity the most.

The SANTAN 4 07/2020 Cedulas Hipotecarias was generating almost 6 points more cash from repoing it with the Eurosystem than the SPGB 4 03/2020 at the height of the sovereign crisis. And what adds to the argument is the higher degree of price stability of Cedulas. Not only was the covered bond generating more liquidity, it was generating the more stable liquidity.

> Figure 8: Liquidity generated from repoing 7Y Santander Cedulas vs. 7Y Bonos



Sources: Bloomberg, Eurosystem, CréditAgricole CIB

This rationale obviously only works for covered bonds, that are already trading deeply inside sovereign debt as mentioned and only in instances where coupons and maturities are comparable. It does not work for covered bonds in core sectors where sovereign debt is still the more ECB repo efficient tool in general. And even in the periphery, the situation is very rating dependent. Below A-, the pendulum swings back towards sovereigns as the repo haircut differences become bigger. Last but not least, one could argue that the liquidity argument is more a reaction to than a cause for negative covered-sovereign spreads.

Bottom line is repo efficiency is not something that would drive covered bonds deeply into negative spread territory relative to sovereign debt. But it is certainly a factor in stabilising spreads once they get there, as it becomes a self-enforcing factor which weighs more the deeper negative spreads are.

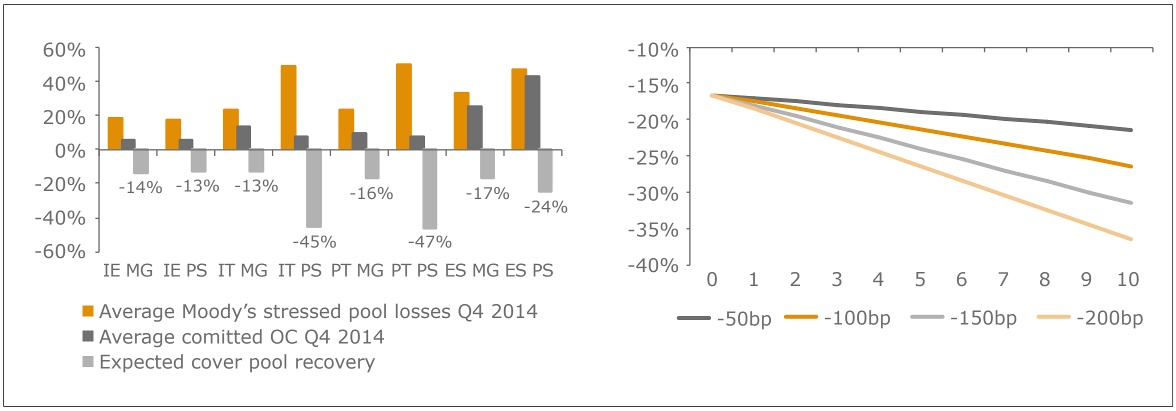
Tail risk – expected recoveries

One of the most powerful arguments that can be brought forward to defend negative covered-sovereign bond spreads is the expectation that tail risk in covered bonds is less than it is in sovereign debt. Especially many long term investors such as insurance companies have started to feel more comfortable with the collateralised claim than the sovereign debt during the sovereign crisis.

When making this argument, it is, however, important to go one step further as the validity of this statement depends on the actual pool backing the covered bonds, the framework regulating it and most importantly as well the issuer itself. Chances that this view will prove right are much higher for high quality residential mortgage backed covered bonds from a country with a strong framework that are issued by a systemically important bank than lower quality public sector backed covered bonds issued by a small non-systemically important issuer. Another important aspect is that the stronger a sovereign is the less relevant are considerations about tail risks and recoveries while they become much more important where sovereigns are in a difficult situation.

It is hard to estimate cover pool recoveries based on issuer reporting. Rating agencies such as Moody's however publish the results of their own cash flow modelling of cover pool assets and liabilities. Moody's stressed pool losses are the loss the agency expects should a cover pool be wound down. One can use this number and apply it to a pool which is left with legal minimum OC to come up with an estimated recovery rate. For Spanish mortgage cover pools for example the estimated loss is slightly less than 20% if the bond was purchased at par (committed OC of 25% and stressed pool losses of 33% at the end of Q4 2014).

> Figure 9: Committed OC, Moody's stressed pool losses, and required sovereign haircut to be better off with covered bonds



Sources: Moody's, Crédit Agricole CIB

This estimated pool recovery figure can be used to either estimate cash prices below a purchase should result in a positive return even if both the bank and the covered bonds default. It can however also be used as a proxy for the required haircut on a sovereign bond that would make the covered bond the better option. In the Spanish case for example, if a sovereign haircut on Spain were to be in excess of 20%, the expected recovery on the Cedulas would be higher. If investors believe the haircut is lower, sovereign debt would be the better option.

If one adds the negative covered-sovereign spread in Spain to the equation, for example in case of Cedulas levels 100bp inside Bonos, the Bonos obviously produces 100bp extra carry p.a. which in effect means that the Bonos investor builds up an additional buffer or 1% p.a. and that this expected recovery moves by 1% to the disadvantage of covered bonds per year. In other words, the better recovery on covered bonds has its price and at some point, the balance shifts to the sovereign debt depending on the cover pool quality, strength of the bank and framework.

What this calculation does not take into account though is the probability that some banks can very well survive a sovereign debt restructuring (via capital support by the domestic sovereign or a European entity and liquidity support by the Eurosystem) and that, irrespective of potential pool recoveries, covered bonds could be the better choice. Countries need to maintain a basic level of banking services and sovereigns would most likely re-capitalise at least some of the country's large retail banks immediately after the sovereign debt restructuring. National Bank of Greece is the best example for this.

Recoveries based investing is something that took place at the height of the crisis when peripheral covered bonds were trading in the 60 to 70 cash price range. At the current price levels which are often well above par the investors that focussed on this for their trading are long gone from covered bond markets. For long term investors that want to assess tail risks, the recovery assessment vs. sovereign debt can however still make sense.

V. HOW DO INVESTORS MANEUVER BETWEEN THE PRODUCTS?

Covered-senior

We believe that one of the reasons for dislocations in spreads between unsecured and secured bank debt has been the limited overlap of senior unsecured and covered bond investors. Many investors still cannot directly play opportunities that arise between both asset classes. The main reasons for the limited overlap are in our view: (1) central banks and sovereign wealth funds are large buyers of covered bonds but not of senior unsecured debt, (2) banks are one of the biggest investor groups in covered bonds and regulatory provisions favour covered bonds, (3) asset managers and pension funds often have higher limits for covered bonds than for senior unsecured bank debt, and (4) both asset classes are usually bought for different dedicated portfolios. In addition, covered bonds are sometimes used to enhance the yield of sovereign bond portfolios without diluting the average rating, or added to genuine credit portfolios to improve the portfolio rating quality.

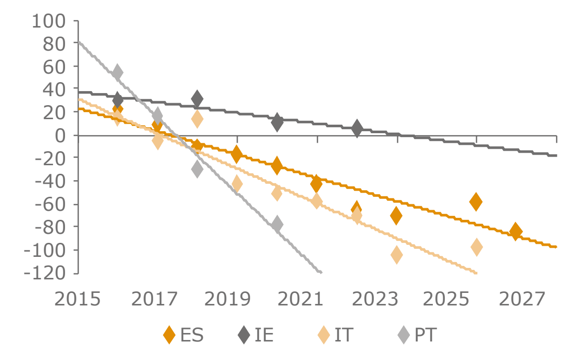
Anecdotal evidence from analysing order books over time, however, suggests that the overlap in the investor base has increased in recent years due to a higher participation of credit investors in new covered bond issues. We expect this trend to continue over the coming years and credit investors to account for a growing portion of covered bond order books going forward, not least because of the bail-in risk for European senior unsecured debt with maturity dates of 2016 and beyond and the relative value opportunities this will create between these two asset classes.

Furthermore, in the current low-yield environment, spreads between covered bonds and senior unsecured paper are to a large extent driven by technicals which maintain spreads at a level below fundamental values.

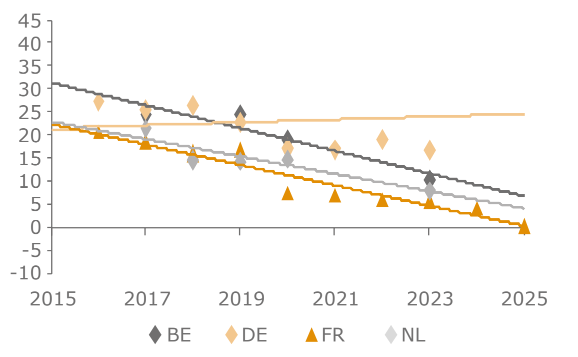
Covered-sovereign

When investors compare covered bonds to sovereign debt there are a number of factors that they take into account. In a very simplified approach, on the one end there is the higher liquidity of sovereign debt and lower capital charge compared to covered bonds while on the other end, spread stability and potential recoveries speak in favour of covered bonds. The liquidity and capital charge arguments pro sovereign debt are valid across the curve. However, while spread stability as well as recoveries are no major topics at the very short end, these topics become more and more relevant the longer a bond is. Consequently covered bond – sovereign bond spread curves should slope downwards over time. And the weaker the sovereign, the stronger the cover pool and the less volatile a covered bond programme is the steeper should the curve slope downwards.

> Figure 10: Covered govie spread curves per country (bp)



> Figure 11: Covered govie spread curves per country (bp)



Sources: Bloomberg, Crédit Agricole CIB

There are a number of countries where we can witness a negative slope in the market. And the curve steepness is also steeper in peripheral markets compared to core sectors.

This does not yet say anything about the absolute level of covered-sovereign spread that is acceptable to investors. We have had new issues price in the primary markets at high double-digit basis points through sovereign debt. We are thus not talking about illiquid secondary screen prices that do not represent reality. We have however compressed in ASW spread terms and pricing deeply through the sovereign if ASW spreads are still above 100bp and differences to other core markets in high double-digit basis points territory is something else than if ASW spreads are around mid-swaps flat. In the former case investors could still hope for spread compression of the affected covered bonds vs. swaps and other covered bond sectors, something that is harder to achieve in the current context.

It is important to note that not all investors focus on the spread to local sovereign debt. Similar to some senior unsecured investors not caring much about covered bond levels and buying at very tight spreads relative to covered bonds, there are investors that will not focus on the spread to sovereign debt. They might have a narrow covered bond mandate not allowing for sovereign debt to be added or they might focus more on alternatives in credit space. For these accounts the spreads relative to other covered bond markets or senior unsecured debt might be more relevant. There are also investors that might not agree with the rationale for or the extent of the negative spreads to sovereigns but are literally forced into buying covered bonds even at deeply negative spread levels. Asset managers receiving fresh cash inflows that do not want to fall behind their benchmark weights while not wanting to hold too much cash at negative rates might invest as well even at deeply negative spreads.

The biggest focus on the covered bond to sovereign debt relationship can probably be found amongst bank treasuries and more generally domestic investors. For many of them the sovereign is still the relevant benchmark and buying into products that produce a significant negative carry vs. the own benchmark is problematic.

What we can say from anecdotal evidence in any case is that investor demand outside the CBPP 3 clearly diminishes at negative spreads to sovereigns in 5Y core sectors such as France. In peripheral markets, we have seen private sector investor buying activity continue until levels of around up to -50bp vs. underlying sovereign debt for the top names in 5Y. Inside these levels the almost exclusive buyer that remains is the CBPP3.

VI. WRAP UP

Covered-senior

We believe that even if the overall yield levels where to rise to more reasonable levels, the yield differential between covered and senior unsecured bonds will have a hard time to get back to its former level. The change in investor demand won't change back over night. If for example a certain fund is set up with a high share of senior unsecured debt vs a low covered bond share, the fund composition stays the same. The CBPP3 has even contributed to this situation. On top of the negative net supply, covered bond allocations for regular investors became even lower due to the high central bank demand forcing them into senior unsecured debt which helps to keep the yield low. Having said that, after the Eurosystem will stop the CBPP3 in October 2016, the demand for covered bonds will go down even more. All this points to a very slow normalisation of the yield differentials between both asset classes.

From an investor's point of view, covered bonds gain attractiveness compared to senior unsecured debt. By accepting only a very low yield give up, investors are able to switch into an instrument of much lower risk and much higher regulatory support. In a low yield environment where every investor is looking for the extra basis point, this argument might not be relevant, but as yield levels go up, risk return considerations should become more import.

To sum it up: During the last 18 months the yield differentials between covered bonds and senior unsecured debt have reached record lows as investors are looking for the extra basis point. The spread stayed relatively low despite the recent widening in yields especially for shorter maturities. This makes senior unsecured bonds more attractive from an issuer's point of view. Despite regulatory developments strongly support covered bonds, the spread between both asset classes is likely to stay low which in return – especially if yield levels where to rise again – favour covered bonds in the eye of an investor.

Covered-sovereign

Spreads of covered bonds to sovereign debt have been driven to a big extent by the ECB's QE programmes. On the downside the disproportionately higher share the CBPP 3 has already acquired in covered bonds has compressed spreads to sovereign debt. On the upside this element of distortion has however also kept spreads very stable during this spring's rates volatility. For many investors this spread stability argument has replaced the recovery argument that was very relevant when cash prices were still in the low to mid seventies for peripheral sectors. Covered bonds especially from the periphery can and will therefore continue to trade through their respective sovereign debt. Since every argument in favour of a certain asset has its price, the extent of covered bonds trading through has its limits. Looking at anecdotal evidence trading from private sector investors slows down substantially at spreads to Bunds of Pfandbriefe around 15bp and negative spread levels in semi core sectors. In peripheral markets, 50bp inside in 5Y for top names has been a relevant number.

Whenever we have traded inside these figures, covered bond investors have waited for sovereign debt to close the gap rather than pushed covered bond spreads wider. Looking forward towards the QE exit, we will however have to move back in line with levels at which private sector investors feel comfortable buying covered bonds without the extreme QE effect. And should sovereign bonds not reduce the covered-govie spread, we will see some covered bond spread widening to close the gap.

2.5 USD AND GBP DENOMINATED COVERED BOND MARKETS

New issuance has revived in 2015 both in the USD- and GBP-denominated markets which remain strategic for covered bonds offering notably diversification opportunities. They benefit from different dynamics than the EUR-denominated market as detailed below. This is notably driven by differences in terms of regulatory treatment (e.g. with respect to Basel's Liquidity Coverage Ratio). From an investor perspective, USD- and GBP-denominated covered bonds may also offer cross-currency arbitrage opportunities depending swap costs which are worth monitoring.

2.5.1 USD-DENOMINATED COVERED BOND MARKET

By Rondeep Barua, Bank of America Merrill Lynch and
Anne Caris, Bank of America Merrill Lynch & Moderator of the ECBC Transparency Task Force

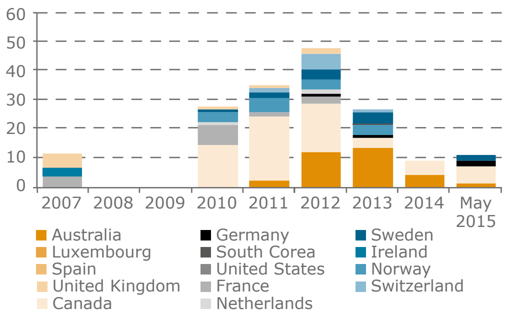
I. ISSUERS RETURN TO THE USD MARKET

Issuance of USD covered bonds dropped sharply in 2014, to under USD10bn benchmark issuance, compared to almost USD30bn in 2013. Unfavourable relative value between EUR and USD issuance and lower USD funding needs for European banks contributed to this fall, in our view. This appears to have changed in 2015, with a faster pace of new issuance, which we believe has been driven in part by movements in the cross currency basis favouring USD issuance (as we show later in this section in our comments on the secondary market). 2014 volumes were matched by mid-April 2015. This revival in USD issuance has been visible in other sectors, such as supranationals and agencies.

Canadian issuers, one of the main sources of USD covered bond issuance before 2013, withdrew from the covered bond market following the introduction of the new legal framework in December 2012. They initially returned to the EUR denominated market under the new framework during 2H13-2014. As the cross currency basis has improved, these banks have also restarted issuance of USD denominated covered bonds since 2H14. Australian banks continue to access the USD covered bond market, though less frequently than in 2012-13, while some of the stronger European issuers have returned to the market in 2015, such as issuers from Germany and the Nordic countries, for example.

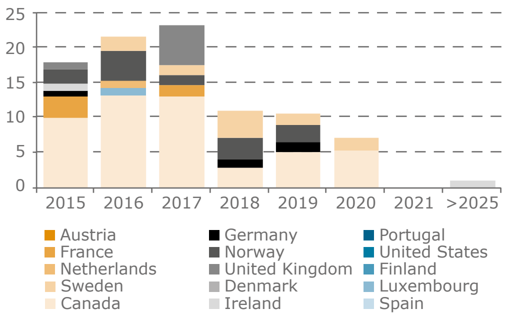
We expect Australian and Canadian banks to further access the market, while the stronger European issuers are likely to continue to use the dollar market as an alternative to the EUR market, in order to diversify funding currencies and investor bases and take advantage of relative value opportunities. Redemptions have also accelerated compared to previous years, another incentive to refinance in order to maintain a curve in the USD market. Furthermore, newcomers might emerge from Asia, eg, Singapore and South Korea, where banks aim to take advantage of their new covered bond legislation.

> Figure 1: USD-denominated benchmark issuance by country (USDbn) [1]



Source: BofA Merrill Lynch Global Research; [1] Excluding FRNs

> Figure 2: USD-denominated benchmark redemptions by country and year (USDbn) [1]



Source: BofA Merrill Lynch Global Research; [1] Excluding FRNs

II. KEY DIFFERENCES TO KEEP IN MIND VS THE EUR MARKET

The USD covered bond market has been more opportunistic than the EUR one for issuers and investors but, nonetheless, remains the second largest. There are several features of the USD covered bond market which we believe differentiate it from its EUR counterpart and may impact market technicals, including:

> An **"AAA" market**: the USD market largely remains a AAA market, as required by most investors. This effectively limits the market to issuers from Australia and Canada, which have largely emerged unscathed from sovereign debt issues of recent years, and the strongest European issuers. While Australian and Canadian issuers have accounted for the majority of USD covered bond issuance historically, a number of European banks tend to use the market as a funding alternative to the EUR denominated market, notably for diversification purposes as mentioned above. In 2015, they have been the second most active after the Canadians accounting for about 40% of total at the end of May.

> **Larger but shorter new issues**: USD covered bonds are typically large, and are mostly "jumbo" like, with few bonds issued with sizes less than USD1bn. Sub EUR1bn bonds are frequently issued in the EUR market on the other hand. The average size of USD covered bond issuance in 2014-15 (as of end-May) was USD1.13bn, compared to EUR0.80bn for EUR covered bonds. USD covered bonds are also typically shorter than EUR covered bonds, with an average original maturity of 4.5 years for USD covered bond issued over the same period compared to 7.3 years for EUR covered bonds.

USD covered bonds are mainly issued in the 144a format. Given the limited issuance of USD covered bonds, the narrower investor base for 144a bonds does not appear to have a material impact on liquidity or pricing of these bonds compared to SEC registered bonds. The 144A format can only be sold to Qualified Institutional Buyers under specific restrictions, unlike the SEC format which opens the door to retail clients as it is the case in Europe with UCITS-compliant covered bonds.

> **Variations in regulatory treatment**: covered bonds receive different regulatory treatment around the world, with the divergence being the highest between Europe and the US in several key areas. Distinction takes into account the issuer's country of origin but also currencies and ratings.

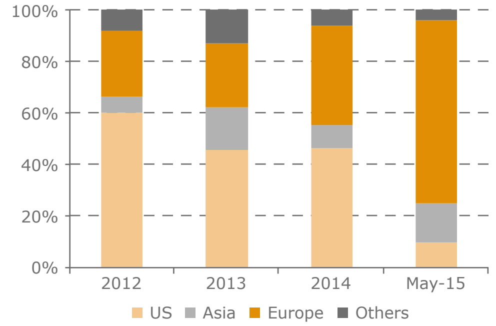
First, covered bonds – including USD-denominated – are favourably treated under the EU implementation of Basel's Liquidity Coverage Ratio (LCR) which allows for covered bonds as part of Level 1, 2A and 2B liquid assets under specific criteria. In contrast, covered bonds – independent of their currency – do not qualify for the LCR in the US and are restricted to Level 2A assets, in line with Basel's recommendation, in other countries such as Canada, Australia or Singapore.

Another key discrepancy is regarding repo eligibility with central banks. The range of eligible covered bonds by country of origin, type (ie, legislative vs structured), currency and rating is widest for the ECB. Bank of England is the second widest, accepting different countries, ratings and currencies, though is somewhat more restrictive than the ECB. This is in contrast to the US Fed which accepts different currencies but AAA German and minimum BBB- US covered bonds only. The central banks in Canada and Australia are also strict focusing on their domestic covered bond market and currency.

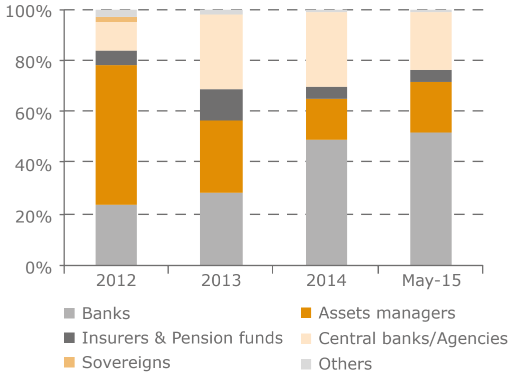
Furthermore, covered bonds are one of the three pillars of the ECB QE with the launch of Covered Bond Purchase programme 3 (CBPP3) in October 2014, which has the following three main objectives: (1) the enhancement of the transmission of monetary policy; (2) facilitation of credit provision to the EUR area economy; (3) generation of positive spill-overs to other markets. This strategic role for covered bonds is again specific to Europe and emphasises the importance of the product.

- **More European buyers recently**: until recently, US investors have accounted for the majority of the investor base for USD covered bonds. However, this appears to be changing, with European and Asian investors playing a greater role in the market. For the few bonds we have distribution data for since the start of 2014, only a quarter of USD issuance has been accounted for by US investors, with European investors accounting for 60% and Asian investors for 15% (and others such as Canadian for 5%). Banks have become the most significant investor type in USD covered bonds since 2014, followed by central banks and agencies. Investing cross currency has been a way to pick up spreads for European investors in the QE world.

> Figure 3: Allocation of USD CB benchmark issuance by country



> Figure 4: Allocation of USD CB benchmark issuance by investor type



Source: Bond Radar LTD

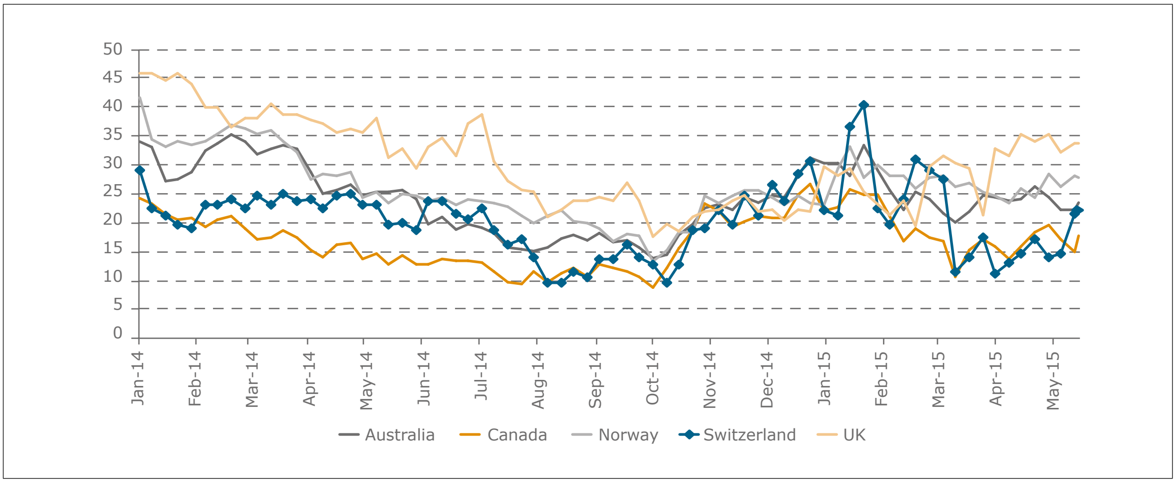
III. CROSS FX BASIS MOVES IN FAVOUR OF USD CBS FOR INVESTORS

In the secondary market for USD covered bonds, spread tiering narrowed across countries in 2014, continuing a trend from previous years. Canadian bonds generally continue to trade at the tightest levels, though Swiss bonds have recently been trading at similar levels since second half of 2014. Australian bonds tend to trade a few basis points wider while USD bonds from European countries tend to trade a few basis points further back on average.

Based on our simple display of the difference between spreads for USD and EUR denominated covered bonds, and indicative swap costs, USD bonds were generally cheap relative to EUR bonds in 2014, particularly at the start of the year. Considering the spread for USD bonds from several banks active in both USD and EUR markets, and subtracting the costs for swapping currencies and swapping the 3 month payments typical for USD bonds to 6 month payments typical for EUR bonds, USD bonds generally offered a spread pickup over their EUR counterparts. However, while currency swap costs have increased since April 2014, spreads for USD bonds have generally increased to a lesser degree, making USD bonds relatively less attractive as an investment (but more attractive as a funding option for issuers, as we noted above).

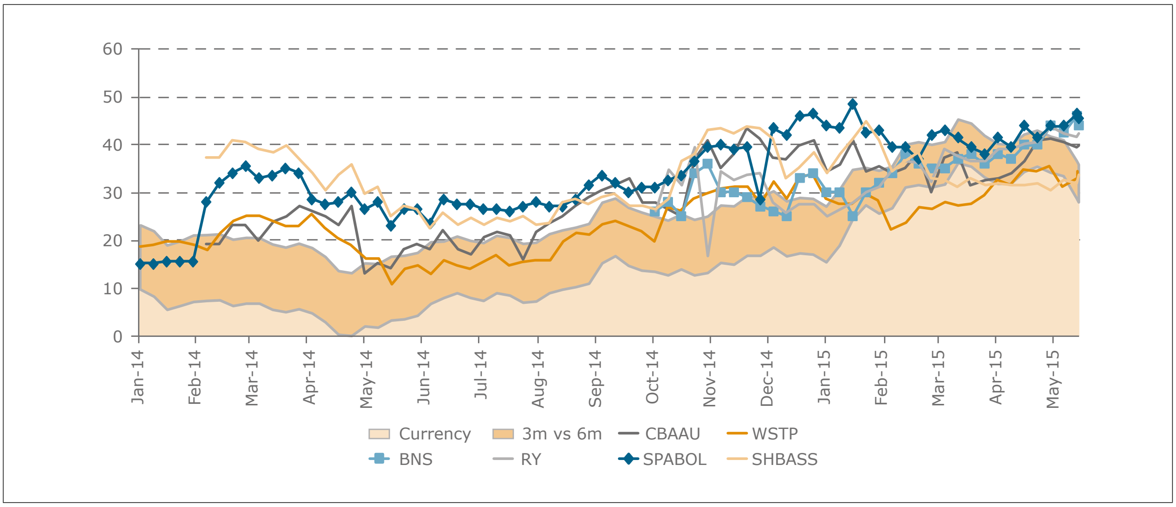
That said, the cross currency basis is decreasing again. Furthermore, the relative value between the two has tended to switch from time to time, and while EUR bonds may appear relatively more attractive at present, potential opportunities between the two markets frequently emerge across names as well as across the curve as it is currently the case notably as a result of the quantitative easing (QE) programme by the European Central Bank (ECB).

> Figure 5: 1-3yr USD covered bond spreads by country



Source: BofA Merrill Lynch Global Research

> Figure 6: 3-5yr USD minus EUR covered bond spreads by issuer and indicative swap costs



Source: BofA Merrill Lynch Global Research, Bloomberg

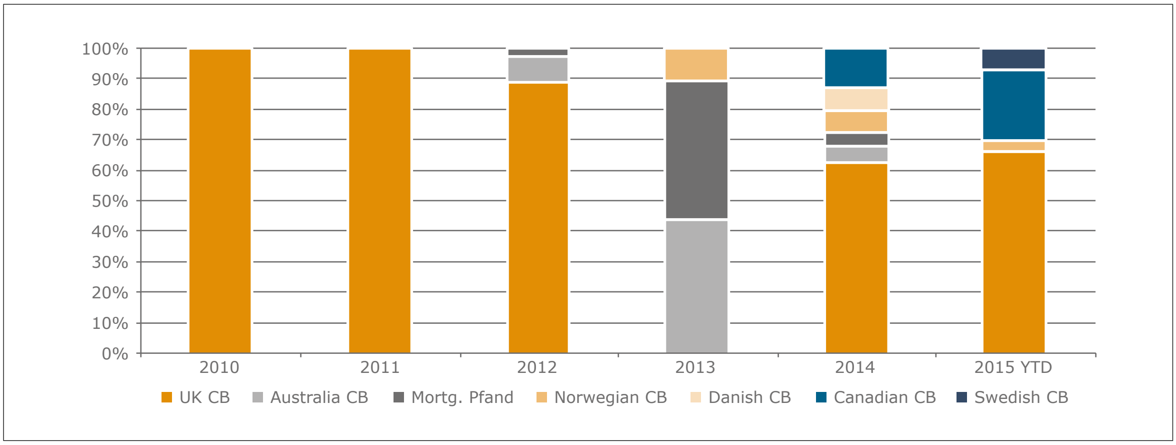
2.5.2 GBP-DENOMINATED COVERED BOND MARKET

By Maxime Claudel and Tim Skeet, Royal Bank of Scotland

The GBP-denominated covered bond market is a small fraction of the total covered bond universe. However, with the entrance of new issuers from non-domestic jurisdictions such as Canada and Australia, the issuance size and volume is set to increase in the future.

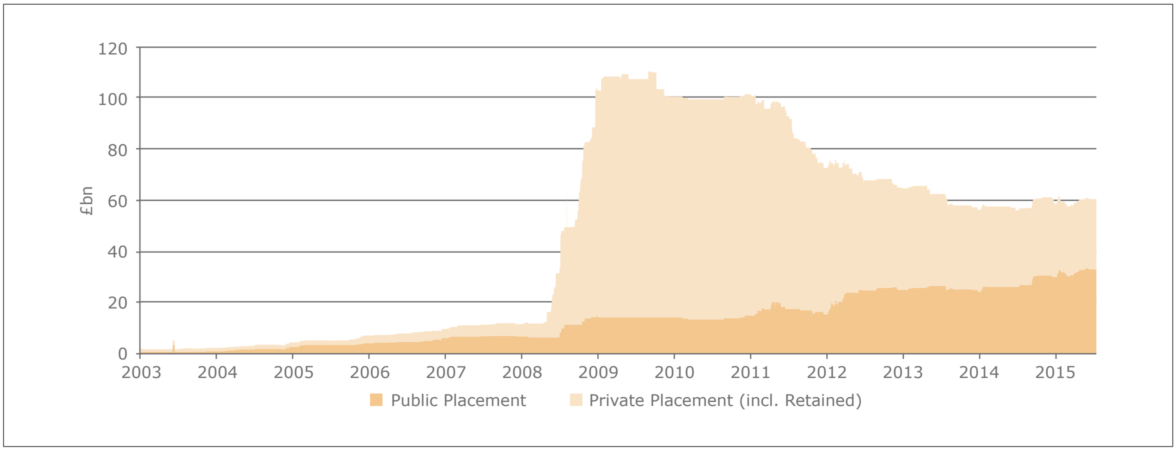
After record new issuance volume in 2012, the GBP covered bond primary market has remained fairly quiet since 2013. However, 2015 year-to-date issuance has marginally surpassed last year's gross supply and is expected to touch c.£10bn by the year-end. Total outstanding publicly placed Sterling covered bonds amount to c.£33bn, or around 54.5% of the overall volume (c.£60.5bn), which also includes private placements and retained issuance. Total outstanding volume peaked in 2009, following high issuance volumes of retained covered bonds at the height of the financial crisis, of which large parts have subsequently been redeemed or matured in the following three years.

> Figure 1: GBP-denominated benchmark covered bonds supply over time



Source: Bloomberg, RBS

> Figure 2: Outstanding volume of GBP-denominated covered bonds over time



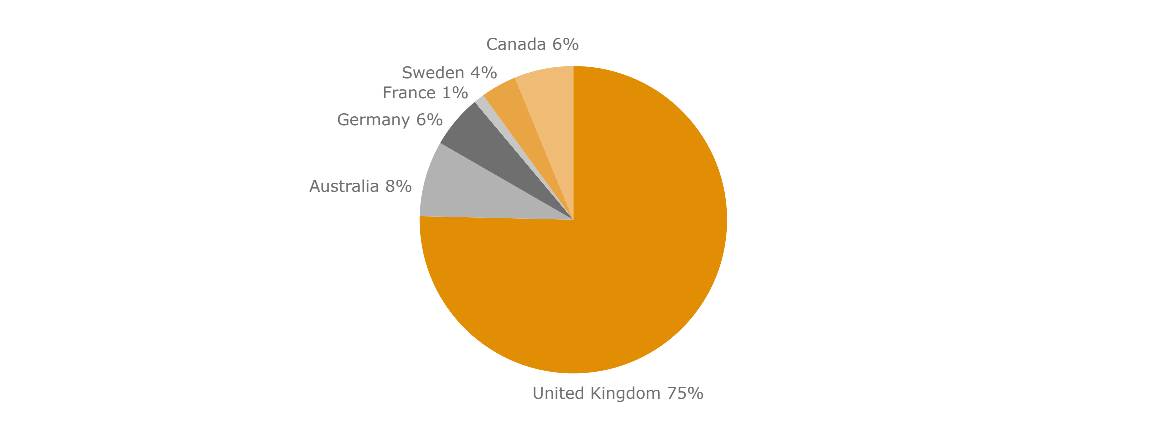
Source: Dealogic, Bloomberg, RBS (data as on 13 July 2015)

In 2012, publicly placed covered bond supply in Pound Sterling reached a record volume of about £13bn, double the volume of the previous year, driven by strong demand from insurance companies at the long end of the curve, as well as money market funds and bank treasuries at the short end.

The GBP-denominated covered bond market has traditionally been dominated by the UK based issuers, however, over the past few years, non-domestic issuers from Australia, Germany, Sweden and Canada have chosen to issue in Sterling.

Issuance in non-domestic currencies has a number of advantages from a covered bond issuer perspective. Besides opportunistic issuance depending on the basis swap valuations to optimise the funding mix, issuers are able strategically to broaden their investor base. Another advantage for issuers is that non-Euro issuance, for instance, reduces the supply in Euros, which should support the valuations of the outstanding Euro benchmarks of the particular issuer and might free up credit lines at investors. Last but not least, issuance in non-domestic currencies can be used to hedge foreign-currency denominated assets in the cover pool without the need to swap currency risk.

> Figure 3: Outstanding volume of public deals by country

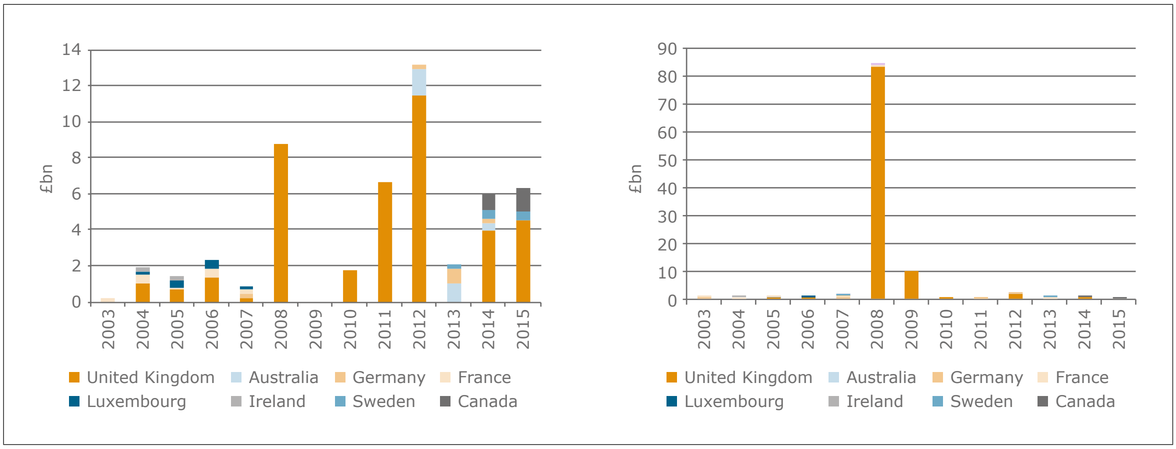


Source: Dealogic, Bloomberg, RBS (data as of 13 July 2015)

The figures below show issuance patterns in the Sterling covered bond segment since 2003, separated into publicly placed deals and private placements (according to the definition by the ECBC Statistical working group), using Dealogic data.

> Figure 4: Publicly placed GBP-denominated covered bond issuance

> Figure 5: GBP-denominated covered bond private placements incl. related issuance



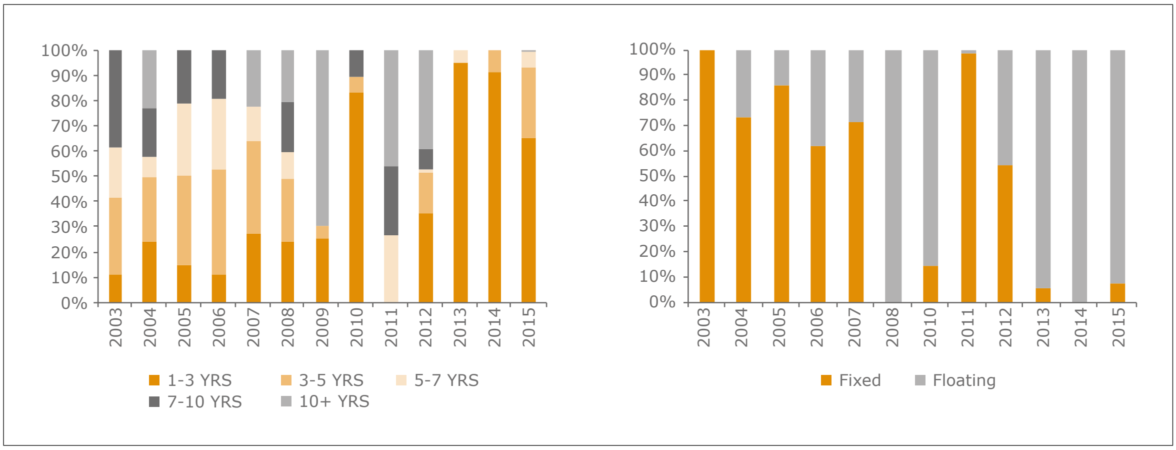
Source: Dealogic, RBS (data as of 13 July 2015)

As shown in the second chart, large volumes of Sterling-denominated covered bonds were issued in 2008 (c.£85bn) and 2009 (c.£10bn) that were not publicly placed in the market. Most of these issues were retained by the issuers at a time when the Bank of England provided funds under the Special Liquidity Scheme in response to the financial crisis. These retained covered bonds were used as collateral.

In the years up to 2008 only a small percentage of new issuance came with maturities longer than seven years. With the exception of 2009 when no syndicated publicly placed issues were sold, demand for long-dated GBP-denominated covered bonds picked up in 2011 and 2012, while the more recent deals thereafter were almost exclusively issued at the short end of the curve, with floating-rate coupons.

> Figure 6: Maturity breakdown of new issuance (public and private placements)

> Figure 7: Breakdown between fixed and floating rate coupons (public placements only)

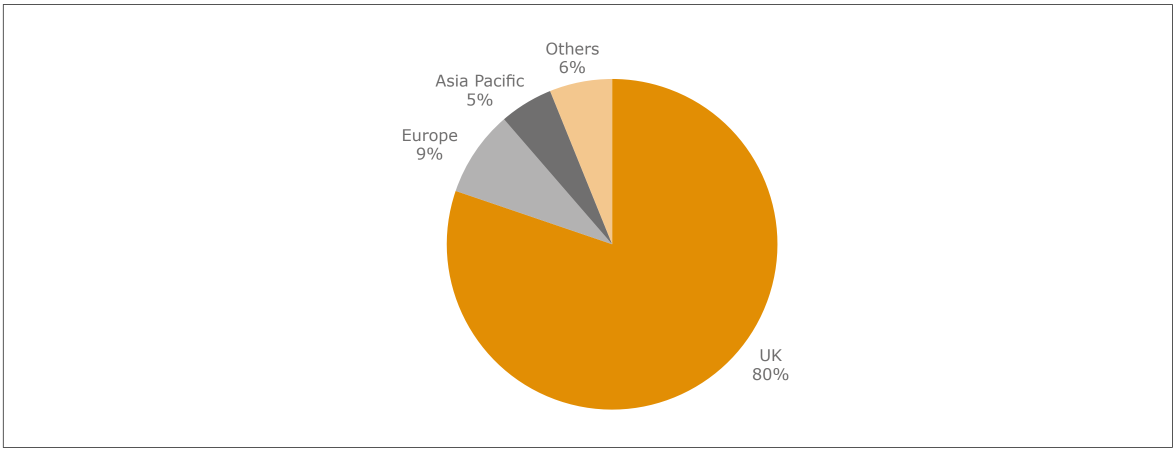


Source: Dealogic, RBS (data as of 13 July 2015)

INVESTOR PARTICIPATION BY GEOGRAPHY

Investors in Sterling-denominated covered bonds are largely based in the UK. Analysing deal allocation statistics of primary market transactions since January 2011 shows that almost 80% has been placed with UK investors with the remainder spread almost equally across Europe and overseas.

> FIGURE 8: INVESTOR PARTICIPATION BY GEOGRAPHY

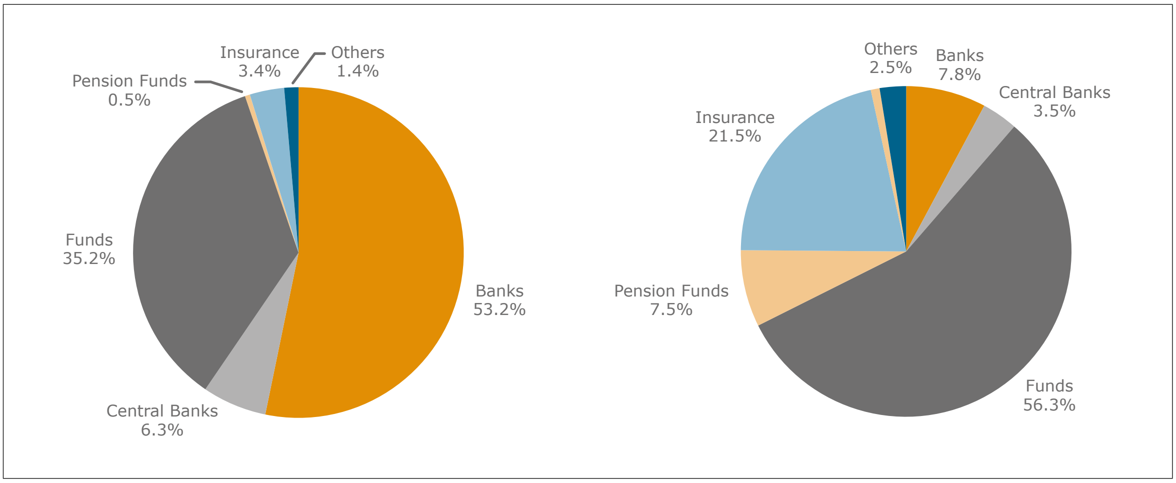


Source: Publicly available deal allocation statistics, RBS (data as of 13 July 2015)

The breakdown of investor base by type varies considerably between floaters and fixed-coupon bonds. While asset managers have a large share of both (35% of FRNs, 56% of fixed-coupon bonds), banks have bought only 8% of fixed rate paper compared to 53% of FRN issues since 2011. Insurance companies and pension funds account for just around 29% of fixed rate covered bonds. This is to a large extent due to the fact that the majority of privately placed fixed-rate bonds in the record years 2011 and 2012 were issued at the long end of the maturity spectrum. One notable development over the last year is the higher take up by the central banks, directly eating into the share of banks' allocation.

> FIGURE 9: INVESTOR PARTICIPATION BY TYPE (FRN)

> FIGURE 10: INVESTOR PARTICIPATION BY TYPE (FIXED)



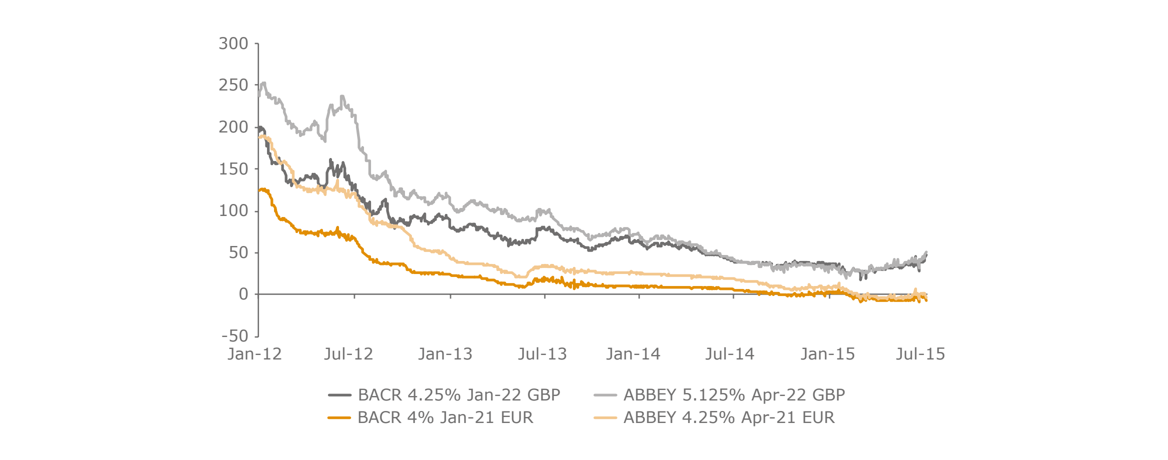
Source: Publicly available deal allocation statistics, RBS (data as of 13 July 2015)

SECONDARY MARKET CROSS CURRENCY OPPORTUNITIES

The direct overlap between the EUR and the GBP markets is relatively small in the publicly-placed benchmark segment. The Sterling-denominated market is largely split between the short-end, with mostly floating-rate issues, and the long-end of the curve; while the biggest part of the corresponding EUR-benchmarks have maturities of less than ten years. Nevertheless, there have been arbitrage opportunities between direct comparables in both segments.

Relative value between GBP and EUR-denominated covered bonds is driven by the developments in the cross-currency basis as well as 3-month vs 6-month swaps. In the recent past, for example, EUR-investors have been able to earn additional spread by buying GBP-denominated covered bonds and hedging the currency risk, compared to making an outright investment in a corresponding EUR Covered Bond. Different investor bases as well as restrictions in investor guidelines that prevent the exploitation are amongst the reasons why such arbitrage opportunities exist.

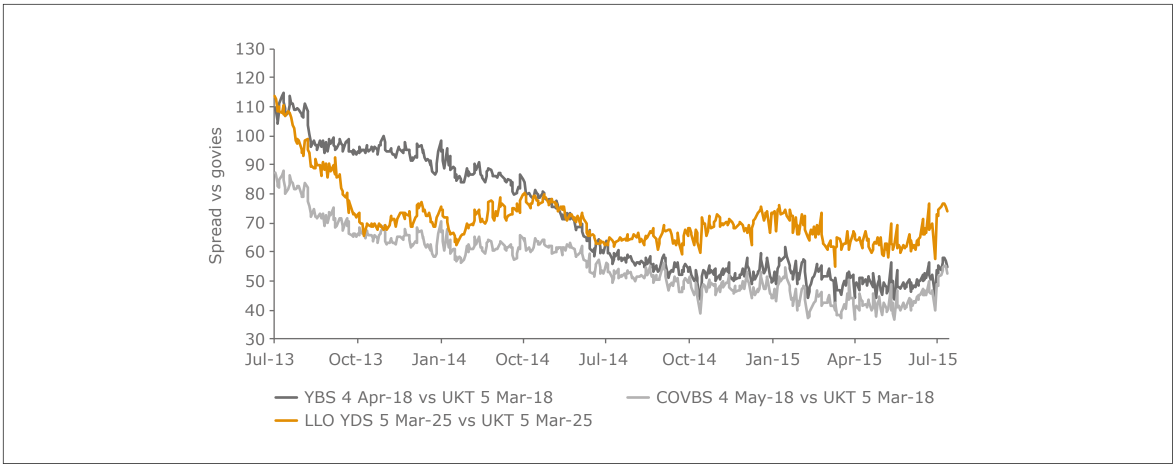
> FIGURE 11: GBP VS EUR COVERED BOND ASW SPREADS



Source: Bloomberg, RBS (data as of 13 July 2015)

From a relative value perspective, GBP-denominated covered bonds provide a decent pick-up to the Gilts with similar maturities.

> Figure 12: Spread vs govies



Source: Bloomberg, RBS (data as of 13 July 2015)

THE WAY FORWARD

Issuance volumes of Sterling covered bonds since 2013 have been subdued, partly driven by the lower funding needs of the UK banks, which have proved to be the backbone for Sterling-covered bond supply over the last few years. The Bank of England's Funding for Lending Scheme and the lower loan demand, combined with a general deleveraging trend in the industry, has resulted in much lower funding needs for UK banks. The supply from non-domestic covered bond issuers highly depends on the basis swap environment which has proved to be very volatile over the years. For domestic issuers, the basis swap currently favours EUR issuance over GBP. Moreover, the two ECB long-term LTROs significantly lowered the wholesale funding needs of euro-area banks, and also affected Sterling covered bond supply from those entities.

Covered bonds are not eligible under the current Liquid Assets Buffer rules in BIPRU 12.7. In 2013, however, the PRA extended the list by an interim definition of level 2 assets limited to 40% of the liquidity requirement and subject to a 15% haircut. CRR-compliant covered bonds issued by credit institutions domiciled in the EEA, Australia, Canada, Japan, Switzerland and the US are included, subject to a minimum rating of AA- and a minimum volume of £/$/€250m, are included in Level 2.

Nonetheless, in June 2015, the UK's Prudential Regulation Authority (PRA) proposed to revoke the liquidity standards contained in BIPRU 12 and phase-in the European Commission's delegated act with regard to the liquidity coverage ratio (LCR), outlining the final rules for liquidity requirements. As per the new guidance, GBP-denominated covered bonds are eligible for Level 1 assets with at least 7% haircut as specified in the EC's Delegated Act. The PRA, however, has clarified that it has no intention to impose additional haircuts on Level 1 covered bonds. The final rules will come into force on 1 October 2015, making GBP-denominated covered bonds more attractive for UK banks to cover their liquidity needs and providing a positive catalyst for the primary market as well.

CHAPTER 3 - THE ISSUER’S PERSPECTIVE

3.1 AUSTRALIA

By Alex Sell, Australian Securitisation Forum

I. FRAMEWORK

The legal framework is principally a contractual one in nature, with a statutory overlay that makes certain provisions for the prudential regulator to make regulations in relation to issuers' covered bond programmes, as well as provisions for minimum overcollateralisation levels (103% at all times).

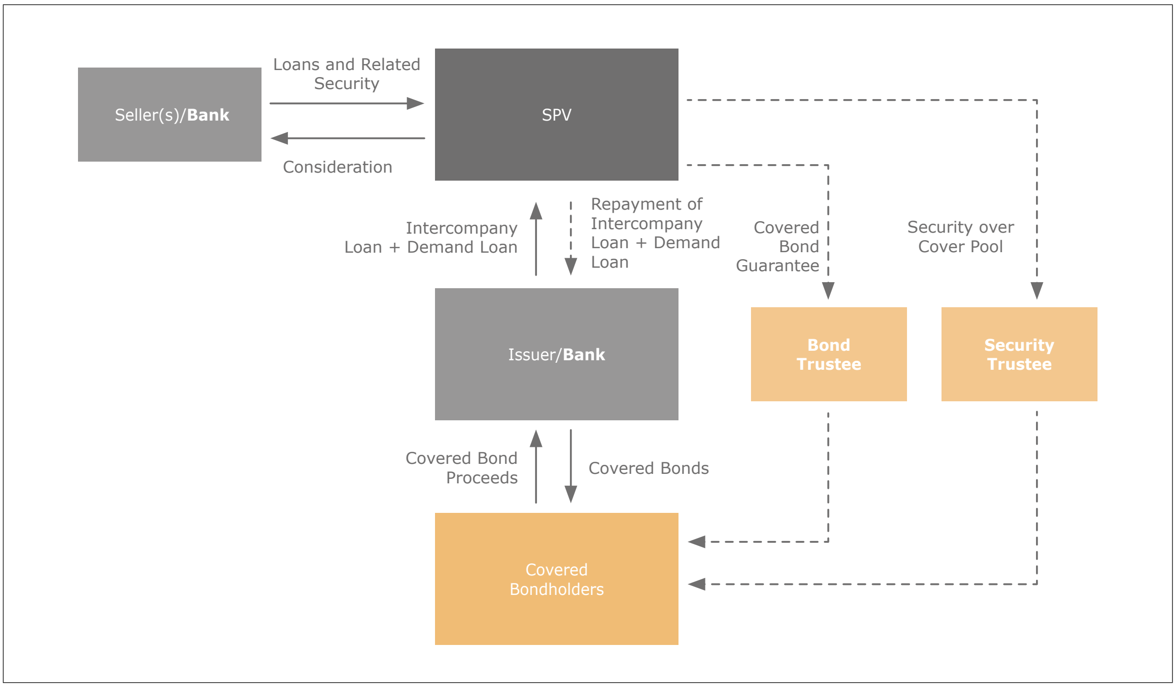
Prior to the introduction of amending legislation, the prevailing view among the regulatory community was that the Banking Act 1959 prohibited banks from placing any other class of creditors above depositors. The amendment to the Banking Act in November 2011 permitted this to occur, subject to an encumbrance limit of 8% (or such other percentage as may be prescribed by regulations) of an issuer's *assets in Australia*, as defined.

II. STRUCTURE OF THE ISSUER

Australian banks are the issuers of covered bonds; not SPVs or any other entity. However, the issuer makes an inter-company loan to the cover pool SPV to enable the SPV to acquire the cover pool and therefore provide a guarantee over the issuer's obligation to bond holders. This guarantee will be called upon in an event of default in respect of the issuer. The cover pool permits the SPV to continue to make scheduled payments on the bonds following an issuer event of default and the bond holders' benefit from security granted by the SPV over the cover pool to secure the SPV's obligations, including in respect of the guarantee. At present, the cover pool assets may not exceed 8% of an issuer's *assets in Australia*. With the exception of the fixed 8% maximum, the Australian covered bond resembles the British and New Zealand models. The charge over the assets of the cover pool does not, however, remove any claim creditors may wish to also make on the estate of the bank issuer.

Under the Banking Act, the cover pool cannot exceed 8% of the issuer's *assets in Australia*. An Authorised Deposit-taking Institution (**ADI**) must not issue a covered bond if the combined value of assets in cover pools securing covered bonds issued by the ADI would exceed this 8% but there may be voluntary overcollateralisation (e.g. in the form of a demand loan) that takes the total value of assets held by the SPV over 8%. The voluntary overcollateralisation may rank equally with covered bonds (thus forming part of the cover pool and subject to the 8% cap) or senior to the covered bonds (thus outside the 8% cap). In keeping with other jurisdictions the voluntary overcollateralisation serves as a management buffer in order to avoid inadvertent contractual breaches in respect of the Asset Coverage Test and to make ongoing covered bond issuance more efficient. Where the voluntary overcollateralisation ranks senior to the covered bonds (i.e. it is not part of the cover pool) such voluntary overcollateralisation remains part of the bank's estate and may be returned to the bank at any time. Further, whilst the bank can exceed the 8% maximum, it will attract a deduction from its regulatory capital base equal to the value that exceeds 8%.

Any amount recovered against the insolvency estate (and for which bondholders rank equally with all other senior unsecured creditors but behind depositors) will be paid over to the SPV to be held as additional collateral which is used to make payments under the guarantee. Any excess of assets in the SPV over and above the amount of the bonds issued – once repaid – will, after the satisfaction of other secured liabilities of the SPV, be paid to the insolvency estate of the issuer by way of repayment of the amount outstanding under any remaining intercompany loan amounts. However where voluntary overcollateralisation ranks senior to covered bond payments, the voluntary overcollateralisation will be returned to the issuer ahead of payments on the covered bonds.


Seller(s)/Bank
Loans and Related Security
Consideration
SPV
Intercompany Loan + Demand Loan
Repayment of Intercompany Loan + Demand Loan
Covered Bond Guarantee
Security over Cover Pool
Issuer/Bank
Bond Trustee
Security Trustee
Covered Bond Proceeds
Covered Bonds
Covered Bondholders

III. COVER ASSETS

The Banking Act 1959 – Section 31[1] sets out the assets that can be included in the cover pool. These are:

a. an at call deposit held with an ADI and convertible into cash within 2 business days;

b. providing no greater than 15% of the total cover pool, a bank accepted bill or certificate of deposit that:

   1. matures within 100 days; and
   2. is eligible for repurchase transactions with the Reserve Bank; and
   3. was not issued by the ADI that issued the covered bonds secured by the assets in the cover pool;

c. a bond, note, debenture or other instrument issued or guaranteed by the Commonwealth, a State or a Territory;

d. a loan secured by a mortgage, charge or other security interest over residential property in Australia;

e. a loan secured by a mortgage, charge or other security interest over commercial property in Australia;

f. a mortgage insurance policy or other asset related to a loan covered by paragraph (d) or (e);

g. a contractual right relating to the holding or management of another asset in the cover pool;

h. a derivative held for one or more of the following purposes:

   1. to protect the value of another asset in the cover pool;
   2. to hedge risks in relation to another asset in the cover pool;
   3. to hedge risks in relation to liabilities secured by the assets in the cover pool.

[1] http://www.austlii.edu.au/au/legis/cth/consol_act/ba195972/s31.html

At the time of publication, all Australian covered bond issuers have limited themselves contractually to excluding any commercial mortgage collateral in their cover pools.

IV. VALUATION AND LTV CRITERIA

Contractually, cover pool assets are subject to revaluation every month by way of indexation, which varies between programmes. Please refer to each issuer's individual website for details of the index used and the methodology applied.

LTV criteria – in addition to indexation – are contained in Section 31A[2] of the Banking Act. Specifically, they are as follows:

> Residential mortgages – if the mortgage exceeds 80% of the value of the property then the value of the loan is reduced by the amount of the excess.

> Commercial mortgages – if the mortgage exceeds 60% of the value of the property then the value of the loan is reduced by the amount of the excess.

V. ASSET – LIABILITY MANAGEMENT

This is principally a matter for the credit rating agencies in relation to timely payment and their opinions on the value of the pool in liquidation scenarios. The issuers have regard to ECAI's methodologies and criteria to seek to ensure maintenance of AAA ratings.

VI. TRANSPARENCY

Since August 2012, an Australian Transparency Template has been in force, followed by each of the five Australian covered bond issuers. It is in line with the guidelines of the ECBC's Covered Bond Label Initiative, and covers the following areas of each issuer's programme:

- Legend
- Dates
- Parties
- Asset Coverage Tests Bond Issuance
- Prepayments
- Pool Summary
- Mortgage Pool
- Contact
- Disclaimer
- Terminology
- Ratings Compliance Tests

Please refer to the Australian Securitisation Forum's covered bonds landing page[3] to access the template in full as well as web links to individual issuer's programmes.

[2] http://www.austlii.edu.au/au/legis/cth/consol_act/ba195972/s31a.html

[3] http://www.securitisation.com.au/cbprofile

VII. COVER POOL MONITOR AND BANKING SUPERVISION

Prudential Standard APS 121 – Covered Bonds[4] contains the regulations set by the administrator (regulator) of the Banking Act in Australia.

The cover pool monitor is appointed by the bank issuer but must be independent and must provide reports in respect of the cover pool to the bank regulator on request. Specific tasks it must perform, and report on, biannually are:

> No breach of the 103% statutory minimum overcollateralisation

> Assess compliance by the issuer with assets permitted to be in the cover pool under the Banking Act

> Confirm that the covered bond pool asset register is being maintained in line with regulation (APS121)

> Contractually, also obliged to check the arithmetic accuracy of asset coverage tests on an annual basis

The bank regulator has the power to instruct – publically or secretly – a bank to cease topping up its cover pool should it wish to invoke its broad powers under the Banking Act, in the event that it has broader concerns about the bank’s prudential condition.

VIII. SEGREGATION OF COVER ASSETS AND BANKRUPTCY REMOTENESS OF COVERED BONDS

Cover pool assets are sold by the bank issuer to the SPV, backed by contract. The security interest held over the cover pool assets is recognised at law and will not be jeopardised in the event of the bankruptcy/insolvency of the issuer.

IX. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

Not in compliance with UCITS because Australian issuers are not domiciled in member states of the EEA.

Risk weighting varies depending upon the jurisdiction concerned, pending standardised risk-weights from the EBA and the outcome of the current Basel consultation.

Covered bonds issued by Australian issuers are currently not eligible assets for repurchase agreements with the ECB or NCBs, or the BoE.

Covered bonds issued by Australian issuers and denominated in Australian dollars are repo eligible with the Reserve Bank of Australia. They are however, deemed to be Level III LCR assets (under the Australian Prudential Regulation Authority’s implementation of Basel III LCR guidelines) and an application for repurchase eligibility with the Reserve Bank of Australia must be made separately for each covered bond issue.

There are no special Australian federal or state investment regulations regarding Australian covered bonds.

X. ADDITIONAL INFORMATION

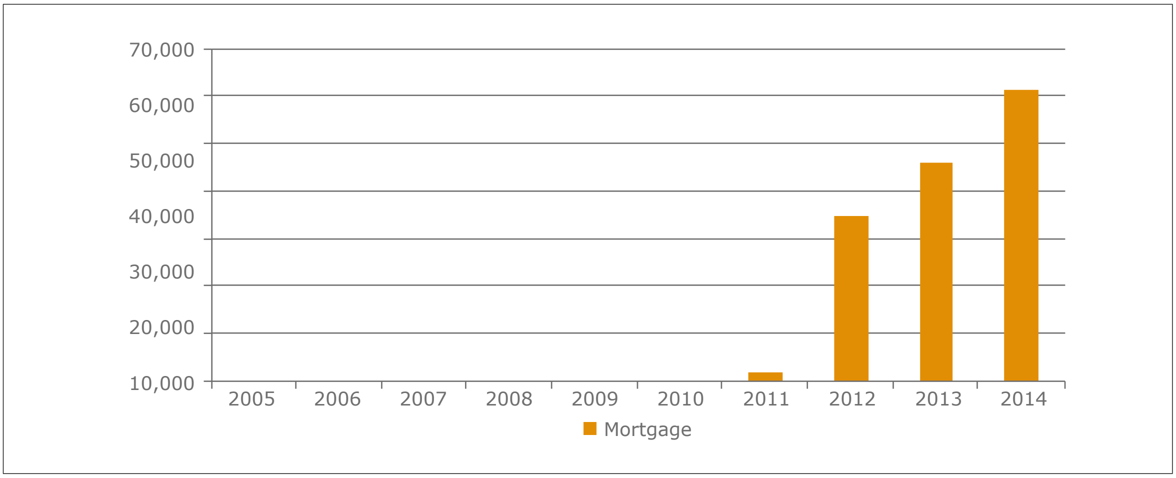
The development of the Australian covered bond market largely came about due to the financial crisis and the effective seizure of non-sovereign global capital markets through this period. After the events of 2008 and 2009, the Australian Federal government recognised the need for increasing funding diversity within the Australian banking system. The Australian Federal government subsequently passed changes to the Banking Act, enabling banks to prioritise claims subject to the regulators interpretation of the changes to the Act. The first covered bond issues from Australian banks occurred in late 2011, with issuance volumes increasing dramatically through 2012 as issuers properly established their programs in global bond markets. Covered bond issuance in 2013 was much lower than that for 2012, as issuers moved from ramping up their programs towards an ongoing program maintenance mode.

[4] http://www.apra.gov.au/adi/PrudentialFramework/Documents/120719-APS121-Covered-bonds-final2.pdf

In principle, Australian ADIs have three primary term funding options for their balance sheets: senior unsecured bonds, residential mortgage backed securities and covered bonds. In practice, the larger institutions have effective access to all three options while smaller institutions principally used senior unsecured bonds and residential mortgage backed securities for term funding. Interestingly, it appears that Master Trusts have been practically excluded from the potential funding mix due to regulatory constraints on the capacity of issuers to pre-define call dates on all liabilities excepting covered bonds.

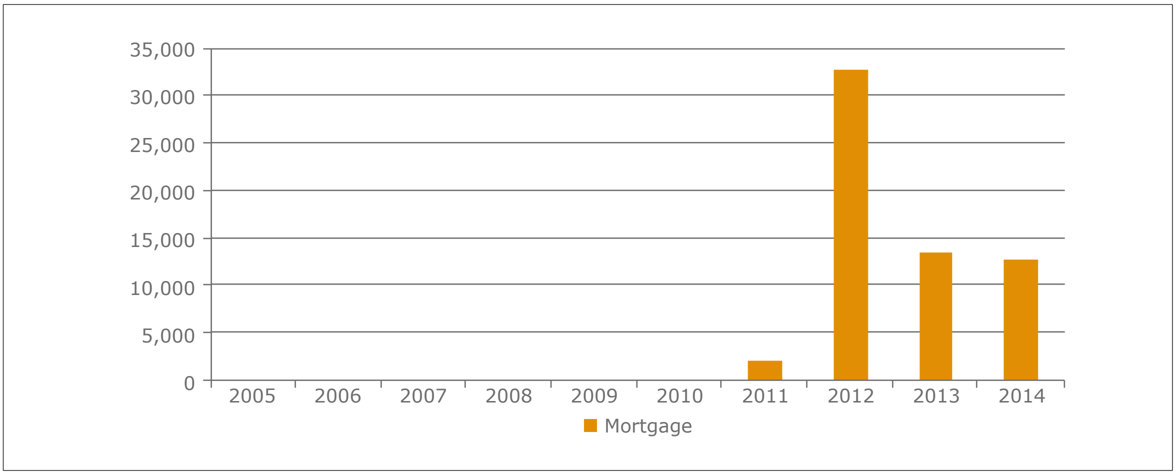
In the future, it is expected that Australian covered bond issuers will use their issuance capacity sparingly; balancing maintaining a global market presence against the higher all-in funding costs associated with covered bonds and program management costs (in comparison to funding through senior unsecured bonds or residential mortgage backed securities), and the need to be able to respond quickly to deterioration in funding conditions. Feedback from a range of market participants suggests that this funding strategy may drive a scarcity premium in terms of the relative valuation of Australian covered bonds against other forms of Australian bank secured financing and other global covered bond markets.

> Figure 1: Covered Bonds Outstanding 2005-2014, EUR m



Source: EMF-ECBC

> Figure 2: Covered Bonds Issuance, 2005-2014, EUR m



Source: EMF-ECBC

Issuers: At present there are five issuers of Australian covered bonds. These are Westpac Banking Corporation, National Australia Bank Limited, Australia and New Zealand Banking Group Limited, Commonwealth Bank of Australia and Suncorp Bank. It is unlikely that other Australian ADIs will be seeking to issue Australian covered bonds. The reason for this is due to the legislative asset encumbrance limit restriction of 8%. This is perceived by many issuers as compromising their ability to support a sufficiently broad market in a prospective programme.

ECBC Covered Bond Comparative Database: http://ecbc.eu/framework/98/Australian_Covered_Bonds.

3.2 AUSTRIA

By Alexa Molnar-Mezei, Erste Group Bank and Friedrich Jergitsch, Freshfields Bruckhaus Deringer

I. FRAMEWORK

Austria has three different frameworks under which covered bonds can be issued. These are:

1. Hypothekenbankgesetz: Mortgage Banking Act (Law of 7/13/1899) "Pfandbriefe"
2. Gesetz betreffend fundierte Bankschuldverschreibungen: Law on Secured Bank Bonds (Law of 12/27/1905) „FBS"
3. Pfandbriefgesetz: Mortgage Bond Act (Law of 12/21/1927) "Pfandbriefe"

Each of these was last amended in 2010.

Under these laws banks can issue two kinds of covered bonds, Pfandbriefe which are issued under the Mortgage Banking and Mortgage Bond Act, and Fundierte Bankschuldverschreibungen (FBS) issued under the Law on Secured Bank Bonds.

Amendments of all three laws have been suggested by Austria's banks to the legislator with the aim of further harmonizing/unifying Austrian Pfandbrief legislation in a single Act, and including, for example, an improved risk management system and standardised reporting requirements to achieve more transparency that offer investors a high level of security in terms of frequency and scope of the reports and ensure that investors receive clearly defined data relating to the cover assets.

II. STRUCTURE OF THE ISSUER

All three laws provide that only duly authorized credit institutions, with a special license to such effect, may issue covered bonds.

The Mortgage Banking Act stipulates a specialist banking provision and this would apply to any new mortgage bank. However, the only 2 issuers under the Mortgage Banking Act currently are universal banks into which former specialised issuers were merged.

The Mortgage Bond Act applies to public-sector "Landes-Hypothekenbanken", which used to be owned by the Austrian provinces and some of which have been privatised.

The Law on Secured Bank Bonds applies to all banks that have a license allowing them to issue covered bonds.

Under all frameworks, the issuer holds the cover assets on its balance sheet (unless it uses another bank's assets as cover, which is permitted under pooling rules contained in all three laws) and the assets are not transferred to a separate legal entity. This means that the covered bonds are an unconditional obligation of the issuer, rather than a direct claim (solely) on the cover assets. In the case of insolvency of the issuer, the cover assets will form a pool which is separate from the issuer's other assets and a special cover pool administrator will be appointed to manage the cover assets. The covered bond holders have a preferential claim on the cover assets.

III. COVER ASSETS

Eligible cover pool assets are loans secured by (predominantly) first-ranking mortgages and public-sector assets. ABS/MBS are not eligible. Pfandbriefe backed by mortgage loans are commonly referred to as "Hypothekenpfandbriefe", while Pfandbriefe backed by public sector assets are referred to as "öffentliche Pfandbriefe".

The Law on Secured Bank Bonds allows mixed cover pools consisting of mortgage loans and public-sector assets but in practice, issuers under that law form separate pools with mortgages and public-sector assets, too, each backing a separate class of covered bonds.

The geographical scope of eligible mortgage assets is restricted to EU / EEA countries and Switzerland.

USA, Canada and Japan are not eligible. For eligible countries that do not recognise the bondholders' insolvency privilege, a 10% limit is in place. For "öffentliche Pfandbriefe", the geographic scope of assets is the same as for "Hypothekenpfandbriefe".

The limits for FBS are similar. In addition to mortgage loans and public-sector assets, FBS may also be backed by assets which, by law, are suitable for investment of a ward's assets ("Mündelgelder"). This includes certain local public bonds, or Austrian Pfandbriefe.

Derivative contracts are allowed in the cover pool if they are entered to hedge interest rate, currency and credit default risks. Derivatives are only allowed for hedging and there is no limit in place on the volume of derivatives in the cover pool.

So-called substitute cover assets are limited to 15% of the amount of covered bonds outstanding and may consist of cash, bank deposits and bonds from public issuers from EEA countries and Switzerland.

IV. VALUATION AND LTV CRITERIA

The Mortgage Bank Act stipulates conditions for property valuation and the value of mortgage lending. One condition is a 60% LTV (loan to value) limit for residential and commercial mortgages based on the so-called "mortgage lending value" (which is a conservatively assessed value).

For Mortgage Bond Act issuers, the 60% LTV limit is stipulated in the statutes of each issuer for historical reasons.

There is no explicit provision for property valuation for FBS but – to our knowledge – issuers mostly adhere to the 60% LTV limit stipulated in the Mortgage Bank Act.

In practice, monitoring of the property value is done by the issuer and regular audits of the cover register are undertaken. Valuation guidelines mostly follow the guidelines prepared by each issuer for solvency purposes, which are approved by the regulator.

V. ASSET – LIABILITY MANAGEMENT

All Austrian covered bond laws contain the matching principle whereby the total volume of assets in the cover pool must at least cover the total nominal amount of outstanding covered bonds, the interest payable on the outstanding covered bonds and potential running costs in case of insolvency of the issuer (expressed under the Mortgage Bank Act and Mortgage Bond Act as mandatory overcollateralization of 2% which must be held in highly liquid substitute cover assets).

In addition, issuers may opt in their statutes to maintain cover on a net present value basis, which is used by many of the international benchmark issuers. Issuers may also provide additional over-collateral at their discretion, for instance in order to meet rating requirements and withstand stress tests.

The legislation also contains a simple maturity matching formula, limiting the issuance of bonds the maturity of which is considerably greater than the maturity of assets in the cover pool.

VI. TRANSPARENCY

The Austrian issuers organised in the Austrian Covered Bond Forum have set up a working group developing and analysing the CBIC Template Guidelines. As a result, Austrian issuers have developed a National Transparency Template –available on the Covered Bond Forum and of the Covered Bond Label websites – with quarterly updates – based on the CBIC European Transparency Standards. The cover pool reports can be found at:

One central website of Austrian Covered Bond Forum: http://www.pfandbriefforum.at/downloads.html

The National Transparency Template includes the following information:

> Programme, Issuer Senior and Covered Bond ratings;

> Overcollateralization values (based on nominal and net present values);

> The total volume of Pfandbrief outstanding as well as the related cover pools in terms of nominal, net present and stressed net present value;

> The share of further cover assets;

> The maturity structure of the Pfandbrief and cover assets;

> Information on the size of the cover assets;

> Information on the mortgages by property type/type of use, region and state;

> Information on the claims against the public sector by state and type of issuer;

> Information on the mortgages registered liens by register country;

> Summary tables including LTV, currency, interest and maturity profile;

> Information on non-performing loans (the percentage of loans more than ninety days past due);

> Information on interest rates and currencies of cover assets and outstanding covered bonds.

The National Transparency Template covers the Guidelines according to the ECBC's Covered Bond Label Initiative that have been introduced in the Transparency Template over the last year by the Austrian Covered Bond Forum. Moreover the items above disclose the information required in Article 129(7) of the Capital Requirements Regulation (CRR).

VII. COVER POOL MONITOR AND BANKING SUPERVISION

The cover pool is monitored by a trustee ("Treuhänder" or, in the case of the Law on Secured Bank Bonds, "Regierungskomissär"), who is appointed by the Minister of Finance. The trustee is liable according to the Austrian Civil Code. The trustee has to ensure that the prescribed cover for the covered bonds exists at all times and that the cover assets are recorded correctly in the cover register. Without his or her approval, no assets may be removed from the cover pool. Any disputes between the issuer and the trustee would be settled by the regulator.

If a concern exists that the rights of the covered bond holders are being infringed, the court must appoint a joint special representative of the covered bond creditors ("Kurator").

VIII. SEGREGATION OF COVER ASSETS AND BANKRUPTCY REMOTENESS OF COVERED BONDS

The Cover Register ("Deckungsregister") in which all cover assets are entered, permits the identification of the cover assets. All mortgages, public-sector loans, substitute cover assets and derivative contracts which form part of to the cover, must be registered in the cover register.

The issuers must inform the debtors (or, as the case may be, counterparties) of the cover assets that their debt (or derivative contract) is made part of the cover pool. On that occasion the issuer must also notify the debtor that it is not allowed to discharge its debt through any set-off. An exemption from the general prohibition of set-off applies to derivative contracts, when the set-off (or netting) occurs in respect of receivables arising under one and the same Master Agreement (i.e. pertaining to the cover assets).

The legal effect of registration is that in the case of insolvency of the issuer, the assets which form part of the separate legal estate (the so called "Sondervermögen") can be identified: All values contained in the register would be qualified as part of the separate legal estate.

While the bank carries out the daily administration of the cover register, it is the cover pool monitor who supervises the required cover und registration in the cover register.

Asset segregation

Cover assets may only be enforced upon by the covered bond creditors (or counterparties of derivative contracts which form part of the cover pool).

If the issuer becomes insolvent, the cover assets are segregated from the remainder of its assets. The cover assets form what is known as ''Sondervermögen'' (pool of special assets) and are earmarked for the claims of the covered bond holders. Any voluntary overcollateralization is also bankruptcy-remote. Only cover assets that are evidently not needed to satisfy the claims of the covered bond holders are passed back to the issuer's general insolvency estate.

The cover assets are managed by a special administrator, who is appointed by the bankruptcy court after consultation with the Austrian regulator (the FMA). The special administrator has the right to manage and dispose of the recorded assets.

Impact of insolvency proceedings on covered bonds and derivatives

Covered bonds are not automatically accelerated in case of insolvency of the issuer, but will be repaid at the time of their contractual maturity. The cover assets are administered in favour of the bond holders and any claims of the covered bond holders in respect of interest or principal repayments are to be paid (primarily) from the cover assets. Equally, in respect of derivatives which belong to the pool, there is no (immediate) legal consequence of insolvency and the counterparty claims as derivative transactions rank pari passu with the claims of the covered bond holders.

Preferential treatment of covered bond holders

Covered bond holders enjoy preferential treatment as the law stipulates the separation of the cover assets on the one hand and the insolvency estate on the other hand. To the extent that they are not satisfied from the cover assets, the covered bond holders may also participate in the issuer's general insolvency proceedings. Only if the cover assets do not suffice to satisfy the covered bond creditors, are the covered bonds accelerated.

Access to liquidity in case of insolvency

Once appointed, the special administrator for the cover pool has the duty to manage the cover pool in order to satisfy the claims of the covered bond holders. The administrator may, for example, sell assets in the cover pool or enter into a bridge loan in order to create liquidity to service the bonds in issue.

The administrator also has access to any voluntary over-collateralisation, which is considered bankruptcy-remote. Any surplus collateral may only be transferred back to the insolvency estate to the extent that it is evident that it will not be needed to cover the claims of the covered bond holders.

Sale and transfer of mortgage assets to other issuers

By virtue of his or her appointment, the special administrator has the right to manage and dispose of the cover assets. In particular, the special administrator must collect the cover assets according to their contractual maturity.

The special administrator is also entitled to sell the assets collectively to a separate credit institution. This institution must then take over all liabilities with regard to the covered bonds. In fact, one of the tasks of the special administrator is to find a suitable credit institution that will buy the assets collectively. If a sale is not feasible, the cover pool administrator has to continue the servicing of the cover pool and the outstanding covered bonds.

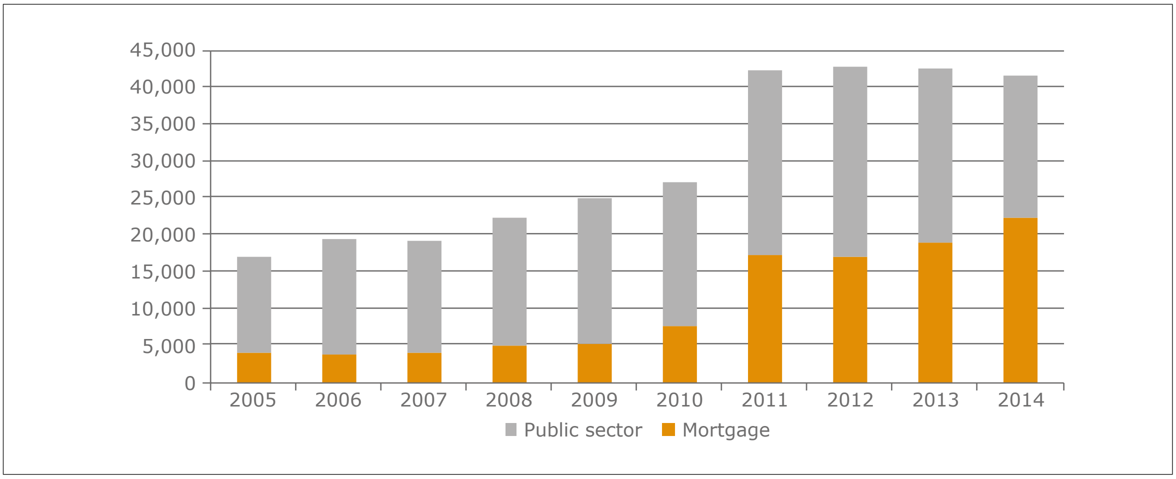
IX. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

The legislation when taken together with the practices, processes and procedures across the industry should fall within the criteria of Article 129 of the CRR. Austrian Pfandbriefe, as well as Austrian covered bonds (FBS), fulfil the criteria of Article 52(4) of the UCITS Directive as well as those of Article 129 of the CRR[1]. This results in a 10% risk-weighting in Austria and other European jurisdictions where a 10% risk-weighting is allowed.

Austrian covered bonds are eligible in repo transactions with the national central bank.

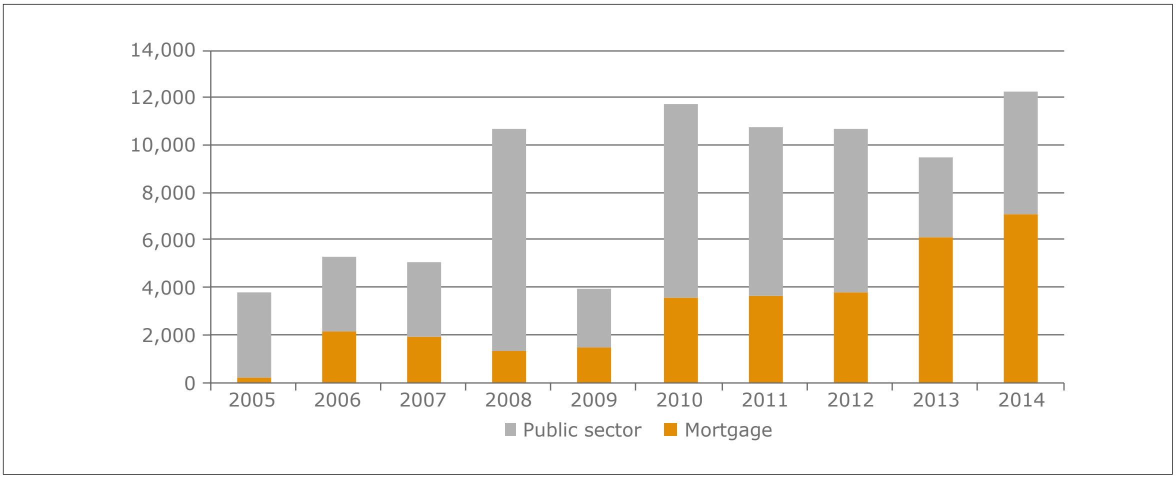
[1] Please click on the following link for further information on the UCITS Directive and the Capital Requirements Regulation (CRR): http://ecbc.hypo.org/Content/default.asp?PageID=504#position.

> Figure 1: Covered Bonds Outstanding, 2005-2014, EUR m



Source: EMF-ECBC

> Figure 2: Covered Bonds Issuance, 2005-2014, EUR m



Source: EMF-ECBC

Issuers: BAWAG P.S.K. Bank für Arbeit und Wirtschaft und Österreichische Postsparkasse AG; Erste Group Bank AG; Allgemeine Sparkasse Oberösterreich Bank; Bausparkasse der österreichischen Sparkassen Aktiengesellschaft; Oesterreichische Volksbanken-Aktiengesellschaft; Kommunalkredit Austria AG; Raiffeisen Bank International AG; Raiffeisenlandesbank Oberösterreich AG; Raiffeisenlandesbank Niederösterreich-Wien AG; Raiffeisen-Landesbank Steiermark AG; Raiffeisen-Landesbank Tirol AG, UniCredit Bank Austria AG; HYPO NOE Gruppe; HYPO Tirol Bank AG; Vorarlberger Landes- und Hypothekenbank Aktiengesellschaft; HYPO Bank Burgenland AG; Hypo Alpe-Adria-Bank International AG; Hypo Alpe-Adria-Bank AG; Hypo Oberösterrich; Hypo Salzburg; Hypo Steiermark; BKS Bank AG; Oberbank AG; BTV-Bank für Tirol und Vorarlberg AG; Sparkasse Schwarz; Raiffeisen-Landesbank Vorarlberg AG; Sparkasse Niederoesterreich.

ECBC Covered Bond Comparative Database: http://www.ecbc.eu/framework/8/Pfandbriefe and http://www.ecbc.eu/framework/95/FBS_-_Fundierte_Bankschuldverschreibungen.

Covered Bond Label **:** UniCredit Bank Austria AG Credit Public Sector; UniCredit Bank Austria AG Credit Mortgage.

3.3 BELGIUM

By Carol Wandels, Belfius Bank

I. FRAMEWORK

On 3 August 2012, the Belgian Parliament adopted the long-awaited legislation on covered bonds. This law provides a statutory framework for the issuance of covered bonds by Belgian credit institutions.

The legal basis for Belgian covered bonds is incorporated into the banking law, meaning the law of 25 April 2014 on the status and the supervision of credit institutions (the "Banking Law") that replaces the Act of 22 March 1993 on the status and the supervision of credit institutions. Since 11 October 2012 the legislation with respect to Belgian covered bonds is supplemented by two Royal Decrees (a general Royal Decree on the issuance of covered bonds and a specific Royal Decree dedicated to the cover pool administrator) and several regulations (inter alia concerning the issuer reporting requirements).

The following gives an overview of the legislative framework for Belgian covered bonds:

> The Law of 3 August 2012 establishing a legal regime for Belgian covered bonds, which is implemented in the Law of 25 April 2014 on the status and supervision of credit institutions (Wet van 25 april 2014 op het statuut van en het toezicht op kredietinstellingen/Loi du 25 avril 2014 relative au statut et au contrôle des établissements de crédit) (the "**Banking Law**");

> The Law of 3 August 2012 on various measures to facilitate the mobilisation of claims in the financial sector (the "**Mobilisation Law**");

> The Royal Decree of 11 October 2012 on the issuance of Belgian covered bonds by Belgian credit institutions (the "**Covered Bond Royal Decree**").

> The Royal Decree of 11 October 2012 on the cover pool administrator in the context of the issuance of Belgian covered bonds by a Belgian credit institution (the "**Cover Pool Administrator Royal Decree**");

> The Regulation of the National Bank of Belgium concerning the practical modalities for the application of the Law of 3 August 2012 that establishes a legal regime for Belgian covered bonds dated 29 October 2012 (the "**NBB Covered Bonds Regulation**"); and

> The Regulation of the National Bank of Belgium addressed to the statutory auditors and the cover pool monitors of Belgian credit institutions with respect to their involvement in the context of the issuance of Belgian covered bonds in accordance with Chapter VIII of the Law of 22 March 1993 dated 29 October 2012 (the "**NBB Cover Pool Monitor Regulation**").

II. STRUCTURE OF THE ISSUER

Belgian covered bonds can be issued by universal credit institutions[1] established in Belgium. However such institutions will first need to be licensed by the NBB as covered bond issuer (general authorisation as issuer) and also the covered bond program itself will need to get approval from the NBB (specific program license).

An extensive issuer license file detailing aspects like its strategy, solvency, risk management, asset encumbrance, IT systems, internal audit, etc. needs to be submitted. At program level the issuer will need to detail the impact of the covered bond issuance on its overall liquidity, the quality of the cover assets and maturity matching of assets/liabilities in the program. The statutory auditor of the issuer will need to report to the NBB on the organizational capacity of the credit institution to issue and follow up the covered bonds.

[1] Existing credit institutions could decide to issue themselves or to issue from a newly created credit institution. The latter would typically but not necessarily be a subsidiary or an affiliate of the mother company.

The license might be conditional upon respecting issuance limits that the NBB on a case-by-case basis might decide on. If licensed, the issuer and the program(s) will be added to specific lists that will be available for consultation on NBB's website.

An indirect issuance limit on covered bonds has been integrated in the Covered Bond Royal Decree by limiting the amount of cover assets to 8% of the balance sheet.

At program level a distinction is made between CRD IV -compliant covered bonds, i.e. "Belgian pandbrieven/ lettres de gage", and non CRD IV-compliant (but still UCITS compliant) covered bonds, i.e. "Belgian covered bonds". The denomination of both terms is protected by law. These distinct types of covered bonds will appear on two separate lists. Consultation of the NBB's website will hence give an overview of:

> Belgian credit institutions issuing covered bonds

> Belgian pandbrieven programs and its specific issuances

However the way that the Banking Law and the Royal Decree are stipulated, makes that in practice the Belgian credit institutions will only be able to issue CRD IV-compliant covered bonds. Therefore in what follows we will only concentrate on the Belgian pandbrieven.

When a credit institution issues Belgian pandbrieven, its assets will by operation of law consist of its general estate on the one hand and (one or more) separate, ringfenced "segregated estate(s)" ("patrimoine special") on the other hand (=balance sheet structure, no use of a special purpose vehicle).

The Belgian pandbrieven investors will have a direct recourse to (i) the general estate of the issuing credit institution (i.e. repayment of the Belgian pandbrieven is an obligation of the issuing bank as a whole) and (ii) the segregated estate, that will comprise the cover pool that is exclusively reserved for the Belgian pandbrieven investors under the specific program to which the segregated estate is joined and for the claims of other parties that are or can be identified in the issue conditions. Assets will become part of the cover pool upon registration in a register held by the issuer for that purpose. As of that moment those assets will form part of the segregated estate and are excluded from general bankruptcy clawback risk.

When insolvency proceedings are opened with regard to the issuing credit institution, by operation of law, the assets recorded in the segregated estate do not form part of the insolvent general estate and hence will not be affected by the opening of the insolvency proceedings. Belgian pandbrieven investors will upon insolvency of the credit institution fall back on the cover pool assets (= the segregated estate) for the timely payment of their bonds but at the same time holders will continue to have a claim against the insolvent general estate. Creditors that are not related to the segregated estate will not have any recourse to these cover pool assets.

III. COVER ASSETS

All assets and instruments that will be legally segregated for the benefit of the Belgian pandbrieven investors in a segregated estate constitute the cover pool. The cover pool can be composed of assets that are part of any of the following categories:

> category 1: residential mortgage loans, and/or senior RMBS

> category 2: commercial mortgage loans, and/or senior CMBS

> category 3: exposure to the public sector, and/or senior public sector ABS

> category 4: exposure on financial institutions

> category 5: derivatives

These five general categories are subject to further eligibility criteria:

- geographical scope: OECD, except for category 1 and 2 that are further restricted to EEA; for category 3 non-EU public sector exposure will get a zero valuation, unless specified otherwise;
- with respect to the MBS/ABS as mentioned in each of the first three categories: senior ABS/MBS are eligible provided that 90% of the underlying pool is directly eligible and is originated by a group related entity of the issuer of the Belgian pandbrieven. The senior ABS/MBS must qualify for credit quality step 1 (as set out in Article 251 CRR[2]). The securitization vehicle of the ABS/MBS must be located in the EU. At last these securitization tranches only remain eligible as cover asset within the limits imposed by the CRD IV;
- for the mortgage loans mentioned in category 1 and 2: the loans need to be guaranteed by first lien (and subsequent lower ranking) mortgages on (residential or commercial) properties located in the EEA. Mortgage loans with properties under construction/in development can only be added to the cover pool if they do not represent more than 15% of all the mortgage loans taken up in the cover pool; Residential real estate is defined as real estate property that is destined for housing or for leasing as housing by the owner. Commercial real estate is real estate property that is primarily used for industrial or commercial purposes or for other professional activities such as offices or other premises intended for the exercise of a commercial or services activity;
- for category 3: exposure to the public sector can only be (i) exposure to or guaranteed or insured by central governments, central banks, public sector entities, regional governments and local authorities or (ii) exposure to or guaranteed or insured by multilateral development banks or international organizations that qualify as a minimum for a 0% risk weighting as set out in article 117 CRR;
- for category 5: derivatives, of which the counterparty has a low default risk (meaning a counterparty that qualifies for credit quality step 1 or step 2 as set out in Article 120 CRR), are only eligible if related to cover the interest rate/currency risk of the cover assets or Belgian pandbrieven. Moreover, a group related entity of the Belgian pandbrieven issuer is not eligible as derivative counterparty unless (i) it is a credit institution that benefits from a credit quality step 1 (as defined in Article 120 CRR) and forms part of the EEA, and (ii) it has a (unilateral) credit support annex (CSA) in place. Note that assets posted under the CSA would belong to the separate legal estate, but are not considered as cover assets as described in this section III. Finally, the derivative contract needs to stipulate that suspension of payments or bankruptcy of the issuer does not constitute an event of default;
- for all of the categories: assets that are delinquent may not be added to the cover pool.

The cover pool can be composed of assets out of each of the five categories. But for each program that is set up (and accordingly for each segregated estate), assets out of one of the first three categories (so either residential mortgage loans, commercial mortgage loans or exposure to public sector) need to represent a value of at least 85% of the nominal amount of Belgian pandbrieven outstanding under such program. In practice this comes down to three types of Belgian pandbrieven programs that can be set up: residential mortgage covered bond program, commercial mortgage covered bond program or public covered bond program. How such value is determined, is explained in the following chapter.

[2] Directive 2013/36/EU of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms (the "**CRD IV**") and Regulation 575/2013 of 26 June 2013 on prudential requirements for credit institutions and investment firms (the "**Capital Requirements Regulation**" or "**CRR**").

IV. VALUATION AND LTV CRITERIA

The valuation rules of the cover assets determine the maximum amount of Belgian pandbrieven that can be issued. The value of the cover assets of each of the categories as mentioned in the section above will be determined as follows:

- category 1: minimum of [the outstanding loan amount, 80% of the value of the mortgaged property, the mortgage inscription amount[3]]
- category 2: minimum of [the outstanding loan amount, 60% of the value of the mortgaged property, the mortgage inscription amount]
- category 3: value is equal to the book value (nominal amount outstanding), except when the counterparties are not part of the EU in which case the value will be zero. There is however an exception to this zero valuation rule for non-EU counterparty exposure:
  - a) in case the non-EU counterparties qualify for credit quality step 1, or
  - b) in case the non-EU counterparties qualify for credit quality step 2 and do not exceed 20% of the nominal amount of Belgian pandbrieven issued

  in either case the value is equal to the book value.
- category 4: no value can be given to this category unless:
  - a) the counterparty qualifies for credit quality step 1, or
  - b) in case the counterparty qualifies for a credit quality step 2, the maturity does not exceed 100 days as of the moment of registration in the cover pool

  in either case the value is equal to the book value.
- category 5: no value is given to this category.
- Additional valuation rule applicable to any category: in case of delinquencies above 30 days, the value as determined per category is reduced by 50%. In case of default (> 90 days), no value can be given anymore.

When it comes to property valuation (applicable to cat 1 and cat 2), in general in Belgium every property is valued during the underwriting process based on either the notarial deed (that includes the property sale price) and/or in case of construction, the financial plan of the architects. It is rather rare in Belgium that the valuation is based on the report of an accredited third party appraiser. In line with the NBB Covered Bonds Regulation, the market value will have to be justified in a clear and transparent manner on the basis of a document established by a person who is independent from the persons who are in charge of granting the relevant loans. An expert report will be required for real estate which has a value of more than 3 million euro or 2% of the amount of the relevant covered bonds. Otherwise, the value of the real estate can be determined on the basis of the sales value as established in the notarial deed at the time of sale or the valuation report of the architect in the case of real estate in construction. The credit institution must apply a prudent revaluation procedure to determine the current value.

The value of the real estate has to be tested regularly. A more regular control shall occur in case of significant changes to the market conditions. To this effect, customary methods and benchmarks (such as third party indices) may be used.

Note that assets can be part of the cover pool without necessarily having a value attached to it, like is the case for the derivatives category, but as well for example for exposure on financial institutions with a maturity above 100 days and a rating below AA-.

[3] This can include Belgian mortgage mandates but upon the condition that there is a first lien mortgage inscription of at least 60% related to one and the same property.

V. ASSET-LIABILITY MANAGEMENT

Each issuer will be required to perform several asset cover tests. The first one has been already mentioned in section III and requires that the value of either category 1, 2 or 3 is at least 85% of the nominal amount of Belgian pandbrieven (the "**85% asset coverage test**"). Secondly the value of the cover assets needs to exceed the nominal amount of Belgian pandbrieven by 5% at all times (5% overcollateralization) (the "**overcollateralization test**"). Finally the sum of the interest, principal and other revenues needs to be sufficiently high to cover for the sum of interests, principal and other costs due under/with regard to the Belgian pandbrieven, as well as any other obligation of the Belgian pandbrieven program (the "**amortization test**").

Next to the asset cover tests, a liquidity test will have to be performed whereby the issuer will calculate its maximum liquidity need within the next 180 days (the "**liquidity test**"). This amount has to be covered by (sufficient) liquid cover assets. In order to meet the test, a liquidity facility could be used to cover liquidity needs, as long as it is not provided by a group related entity of the issuer. Liquid assets are assets that (i) meet the cover asset eligibility criteria and (ii) qualify as liquid assets under the Regulation of the Banking Finance and Insurance Commission (CBFA) of 27 July 2010 on the liquidity of credit institutions, financial holdings, clearing institutions and institutions assimilated with clearing institutions.

If an issuing credit institution fails to meet the requirements of the liquidity test, it will have 14 days to take the necessary redress measures to meet the relevant requirements. As long as an issuing credit institution has not taken the necessary redress measures, it is not allowed to issue new Belgian covered bonds.

The issuer will also be required to manage and limit its interest and currency risk related to the program and will be able to sustain severe & averse interest/exchange rate movements. Although it is the issuer's sole discretion to determine how this will be managed (e.g. adding derivatives to the cover pool is a possibility (subject to eligibility criteria) but not an obligation) it needs to be documented in the license application.

At last it is important to highlight that the tests have to be met on a daily basis.

It is the task of the cover pool monitor to verify at least once a month if the issuer is compliant with all the tests.

Other safeguard mechanism that are foreseen:

> Issuer will have the possibility to retain its own Belgian pandbrieven for liquidity purposes

> Commingling risk:

  > collections received from cover assets as of the date of bankruptcy will by law be excluded from the insolvent general estate.

  > registered collections received from the cover assets before the date of bankruptcy are part of the separate estate and legally protected via the right of 'revindication'. This is a special mechanism that has been created to protect cash held by the issuer for the account of the segregated estate. Pursuant to this mechanism, the ownership rights of the special estate as regards cash that cannot be identified in the general estate, will be transferred to unencumbered assets in the general estate that will be selected by taking into account criteria specified in the issue conditions.

> Set-off and claw back risk: solved through the Mobilisation Law.

VI. COVER POOL MONITOR AND BANKING SUPERVISION

In its capacity as a Belgian credit institution licensed to issue Belgian pandbrieven, the issuer is subject to special supervision by the NBB as well as the supervision by a cover pool monitor.

The cover pool monitor:

- is chosen by the issuer from those persons appearing on the official list of certified/statutory auditors established by the NBB;
- shall be appointed subject to prior approval from the NBB;
- cannot be the certified/statutory auditor of the issuer.

The main tasks of a cover pool monitor consist of ensuring compliance with legal and regulatory requirements, e.g. are the cover assets duly recorded in the register, do the cover assets fulfil the eligibility criteria, is the value correctly registered, etc. The cover pool monitor is required to perform these tasks not only on an on-going basis, but also prior to the first issuance of Belgian pandbrieven by the credit institution. The on-going verifications must be done at least once a month.

Next to that the cover pool monitor has a reporting obligation towards the NBB on several aspects such as level of overcollateralization and results of the different tests that have to be performed. The issuer is obliged to provide full cooperation to the cover pool monitor and shall give the cover pool monitor the right to review the register, loan documents, accounting book, or any other document. The NBB at its discretion can ask the cover pool monitor to perform other tasks and verifications.

If the NBB considers that a category of Belgian pandbrieven no longer fulfills the criteria or the issuer no longer fulfills its obligations, it can withdraw the license of the issuer and consequently withdraw the issuer from the list of Belgian covered bond issuers. Such a deletion from the list will be reported to the European Commission but does not have consequences for existing Belgian pandbrieven holders.

VII. SEGREGATION OF COVER ASSETS AND BANKRUPTCY REMOTENESS OF COVERED BONDS

Assets need to be registered before they form part of the segregated estate. The law protects these registered assets (including all collateral and guarantees related to such assets) from a claim of the creditors of the insolvent general estate and are therefore not affected by the start of insolvency proceedings against the issuer. Also, any assets that would be posted via a CSA that is in place would be protected from insolvency proceedings as it is required to register these type of assets as well, although as explained before one cannot consider those as pure cover assets.

The cover assets once registered are exclusively and by operation of law reserved for the benefit of the Belgian pandbrieven investors and other creditors that might be linked to the program (e.g. a swap counterparty of which the derivative is included in the cover pool). These creditors also have a claim on the general estate. Only when all obligations at program level have been satisfied, will any remainder of assets of the separate estate return to the general estate of the issuer. Before such time, the bankruptcy receiver of the credit institution, in consultation with the NBB, could ask the restitution of cover assets if and when there is certainty that not all assets will be necessary to satisfy the obligations under the Belgian pandbrieven program.

Upon the initiation of bankruptcy proceedings or the instruction of an exceptional recovery measure by the competent supervisor with regard to the credit institution, or even before whenever the NBB considers it to be necessary (e.g.at the moment the license is withdrawn), a cover pool administrator ("gestionnaire de portefeuille") will be appointed that will take over the management of the Belgian pandbrieven program from the credit institution. The cover pool administrator (appointed by the NBB) is legally entrusted with all powers that are necessary for the management of the segregated estate, and can take all such actions (some in consultation with/upon approval of both the NBB and the representative of the noteholders) required to fulfill in a timely manner the obligations under the Belgian pandbrieven. Such actions could consist in (partial) sale of the underlying cover assets, taking out a loan, issuance of new bonds to use for ECB purposes or any other action that might be needed to fulfill the obligations. Acceleration of the Belgian pandbrieven is not possible, unless after the appointment of a cover pool administrator:

> noteholders would decide otherwise;

> (after consultation with the noteholders’ representative and with the consent of the NBB) it is clear that further deterioration of the cover assets would lead to a situation whereby it is impossible to satisfy the obligations under the Belgian pandbrieven (i.e. in a situation of insolvency of the cover pool).

The bankruptcy receiver has a legal obligation to cooperate with the NBB and the cover pool administrator in order to enable them to manage the special estate in accordance with the law.

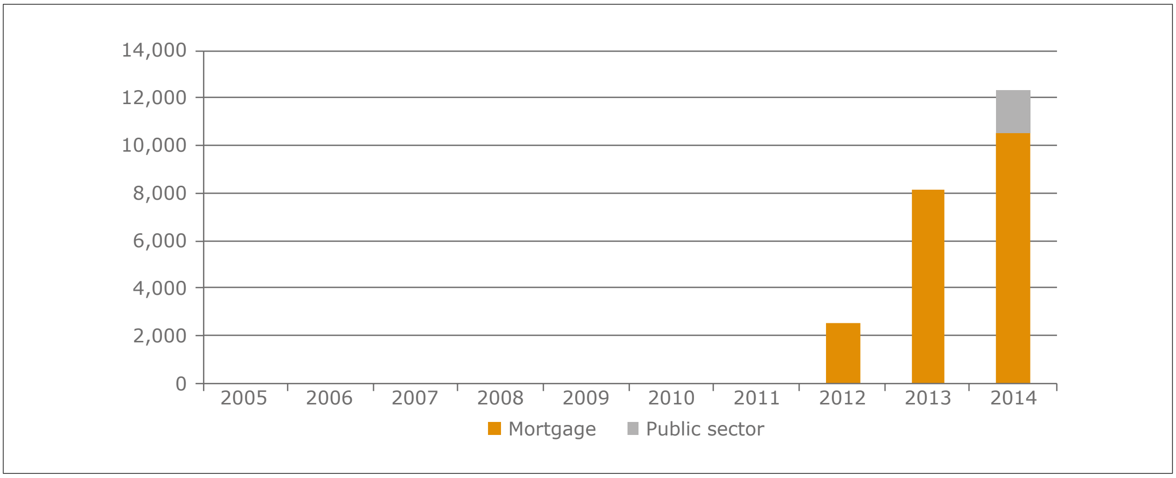
The Cover Pool Administrator Royal Decree specifies the tasks of the cover pool administrator. These include, amongst other things, to procure the payment of interest and principal on the Belgian covered bonds, collection of moneys from the cover assets (including any enforcement), entering into relevant hedging and liquidity transactions and carrying out of certain administrative tasks. The cover pool administrator will also have to test compliance with the cover tests and inform the NBB and the noteholders’ representative thereof.

VIII. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

The legislation when taken together with the practices, processes and procedures across the industry should fall within the criteria of Article 129 CRR.[4] Belgian pandbrieven will comply with the requirements of Article 52(4) UCITS and Article 129 CRR if and to the extent they are listed by the NBB as such.

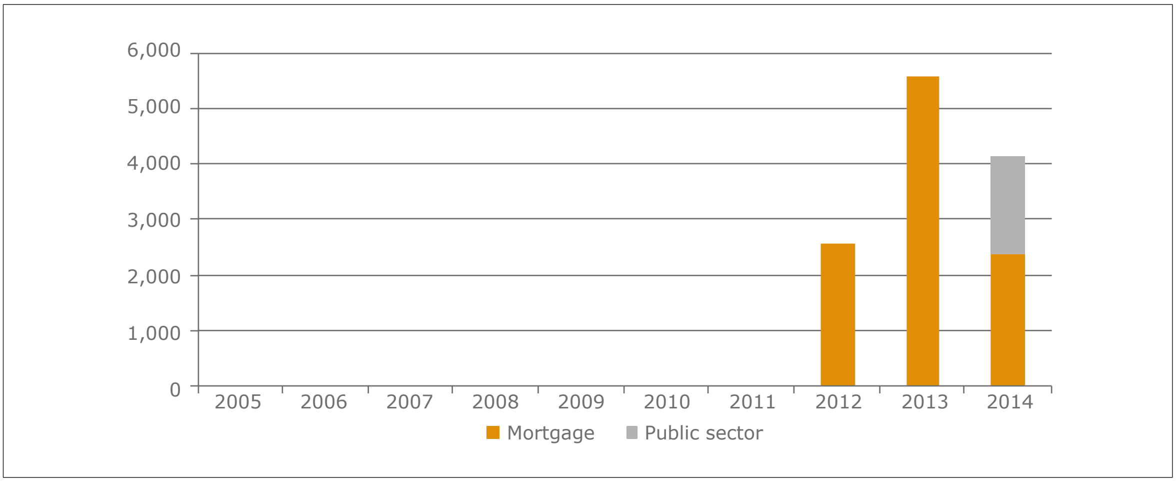
[4] Please click on the following link for further information on the UCITS Directive and the Capital Requirements Regulation (CRR): http://ecbc.hypo.org/Content/default.asp?PageID=504#position.

> FIGURE 1: COVERED BONDS OUTSTANDING, 2005-2014, EUR M



Source: EMF-ECBC

> FIGURE 2: COVERED BONDS ISSUANCE, 2005-2014, EUR M



Source: EMF-ECBC

Issuers: Belfius, KBC and ING Belgium.

ECBC Covered Bond Comparative Database: http://ecbc.eu/framework/100/Belgium_Covered_Bonds.

3.4 BULGARIA

By Yolanda Hristova, UniCredit Bulbank AD and Franz Rudolf, UniCredit

I. FRAMEWORK

In Bulgaria, the legal basis for the issue of covered bonds is the Mortgage-backed Bonds Law issued by 38th National Assembly on 27 September 2000, published in the State Gazette (*Darzhaven vestnik*) issue 83 of 10 October 2000[1].

II. STRUCTURE OF THE ISSUER

Pursuant to the Mortgage-backed Bonds Law, the mortgage-backed bonds shall be securities issued by banks on the basis of their loan portfolio and secured by one or more first in rank mortgages on real estate in favour of banks (mortgage loans). Only banks may issue bonds called mortgage-backed bonds.

The real estate under the previous paragraph shall be insured against destruction and shall be of the following type:

> Housing units, including leased out;

> Villas, seasonal and holiday housing;

> Commercial and administrative office spaces, hotels, restaurants and other similar real estate; and

> Industrial and warehousing premises.

The issuing bank shall adopt internal rules on conducting and documenting mortgage appraisals of real estate which shall comply with the requirements of Article 73, paragraph 4 of the Bulgarian Law on Credit Institutions.

Securities issued under procedures other than the one laid down by the Mortgage-backed Bonds Law may not referred to with, or include in their appellation, the extension "mortgage-backed bond", or any combination of these words.

III. COVER ASSETS

The outstanding mortgage–backed bonds shall be covered by mortgage loans of the issuing bank (principal cover). To substitute loans from the principal cover that have been repaid in full or in part, the issuing bank may include the following of its assets in the cover of mortgage-backed bonds (substitution cover):

> Cash or funds on account with the Bulgarian National Bank (BNB) and/or commercial banks;

> Claims on the Government of the Republic of Bulgaria or the Bulgarian National Bank, and claims fully secured by them;

> Claims on governments or central banks of states as determined by the Bulgarian National Bank;

> Claims on international institutions as determined by the Bulgarian National Bank;

> Claims fully backed by government securities issued by the Government of the Republic of Bulgaria, the Bulgarian National Bank, the Governments, Central Banks or international institutions;

> Claims secured by gold; and

> Claims fully backed by bank deposits denominated in Bulgarian levs or in a foreign currency for which the BNB quotes daily a central exchange rate.

[1] Amended; issue 59 of 2006; in force on the date of entry into force of the Treaty of Accession of the Republic of Bulgaria to the European Union; amended; issues 52 and 59 of 2007; amended; issue 24 of 2009; effective as of 31 March 2009.

The substitution cover of mortgage-backed securities shall not exceed 30% of the total amount of liabilities of the issuing bank under that issue. Mortgage-backed Bonds cover from any issue (the sum total of the principal cover and the substitution cover) may not be less than the total amount of liabilities towards the principals of mortgage-backed bonds from that issue which are outstanding and in circulation outside the issuing bank.

The claims of the bondholders under mortgage-backed bonds from each issue shall be secured by a first pledge on the assets of the issuing bank included in the cover of that issue. The pledge is a subject of entrance in the Central Registers of Special Pledges, with the respective issue of mortgage-backed bonds being indicated as a pledge creditor.

The issuing bank shall request an entry and submit to the Central Register of Special Pledges all data required for the entry of the pledge within one month after executing a mortgage-backed bonds issue and shall update that data at least once every six months thereafter. The pledge shall remain in force until the full redemption of the liabilities of the issuing bank under the respective issue of mortgage-backed bonds without the need for any renewal. Deletion of the pledge entry shall be made upon the full redemption of the issuing bank's liabilities under the respective issue of mortgage-backed bonds on the basis of a document issued by the bank's auditors.

IV. VALUATION AND LTV CRITERIA

Valuation

Mortgage appraisals of property shall be performed by officers of the issuing bank or by physical persons designated by it having the relevant qualifications and experience.

For appraisals of the property the comparative method, the revenue method and the cost-to-make method shall be used for the purposes of the law.

The mortgage appraisal shall explicitly specify the method or combination of the above methods used with the relative weight of each method in the appraisal, as well as the sources of data used in the analysis and calculations.

Subsequent mortgage appraisals of property used as collateral on the loans recorded in the register of mortgage-backed bonds cover shall be made at least once every twelve months for loans which:

- Have outstanding liabilities exceeding 1% of the issuing bank's own funds; or
- Have not been consistently classified as standard risk exposures throughout that period.

LTV criteria

LTV criteria are generally defined in the banks own lending policies depending on their risk appetite and other internal rules. No specific legal requirements are imposed by the local banking law.

V. ASSET – LIABILITY MANAGEMENT

Art.6 of the Law on Mortgage-backed Bonds stipulates that mortgage loans shall be included into the calculation of the principal cover at the value of their outstanding principal but at no more than 80% of the mortgage appraisal value of the real estate as housing units, including leased ones, and at no more than 60% of the mortgage appraisal value of the real estate as villas, seasonal and holiday housing units used as collateral on mortgage loans.

Substitution cover of mortgage-backed bonds from any issue may not exceed 30% of the total amount of liabilities of the issuing bank under that issue.

Mortgage-backed bonds cover from any issue (the sum total of the principal cover and the substitution cover) may not be less than the total amount of liabilities towards the principals of mortgage-backed bonds from that issue which are outstanding and in circulation outside the issuing bank.

In making calculations under the previous paragraph for mortgage-backed bonds and assets constituting their cover denominated in different currencies, the official foreign exchange rate for the Bulgarian lev to the respective currency quoted by the Bulgarian National Bank of the day of the calculation shall apply.

A loan recorded in the register of the cover of mortgage-backed bonds from a particular issue may be repaid at any time by bonds of the same issue at their face value.

VI. TRANSPARENCY

Banks (the only eligible issuers of mortgage bonds) produce regular reporting to Banking Supervision authority – Bulgarian National Bank (BNB), and provide and publish financial information on a monthly basis. The public banks are reporting issuers and submit all required information to the regulated market – Bulgarian Stock Exchange – Sofia (BSE), as well as to the Bulgarian Financial Supervision Commission (FSC). No additional specific measures in respect to the mortgage bonds are currently announced.

VII. COVER POOL MONITOR AND BANKING SUPERVISION

Cover pool is managed by the issuing bank which should have adopted internal rules for maintaining the cover pool, the rules for access to the cover pool data base and the regularity of the update of the cover.

Bulgarian National Bank carries out general assessment of the banks, including issued mortgage bonds as part of general banking supervision.

VIII. SEGREGATION OF COVER ASSETS AND BANKRUPTCY REMOTENESS OF COVERED BONDS

After the record of the assets in the register as a cover of mortgage-backed bonds of a particular issue may be used as collateral solely for the liabilities of the issuing bank on that issue. The issuing bank may not allow any encumbrances on its assets constituting the cover of outstanding mortgage-backed bonds. The issuing bank accounts assets recorded in the register of mortgage-backed bonds cover separately from the rest of its assets.

The issuing bank shall keep a public register of the cover of mortgage-backed bonds issued by it as the register is kept separately by mortgage-backed bonds issue.

In case of declaring the issuing bank bankrupt, the assets recorded as of the date of declaring the bank bankrupt in the register of the mortgage-backed bonds cover shall not be included in the bankruptcy estate. Proceeds from the liquidation of assets recorded in the register as a cover on a particular issue of mortgage-backed bonds are distributed among the bondholders from that issue in proportion to the rights under their bond holdings. Any funds remaining after settling the claims under mortgage-backed bonds from a particular issue is included in the bankruptcy estate.

The asset pool under the above mentioned paragraphs are managed by a holders' trustee of mortgage-backed bonds which is appointed by the bankruptcy court when it has been established that the bank has outstanding liabilities under mortgage-backed bonds. The trustee is managing the assets by individual mortgage-backed bonds issue.

The Trustee shall have the powers of an assignee in bankruptcy in respect of the asset pool described above, as well as in respect of any outstanding liabilities of the issuing bank under mortgage-backed bonds.

The Trustee shall manage the above mentioned assets separately for any mortgage-backed bond issue. The Trustee shall sell the above described assets under the procedure set forth in Articles 486-501 of the Civil Procedure Code and shall account any proceeds to an escrow account opened for each issue with commercial banks as determined by the Bulgarian National Bank. The Trustee shall publish in the State Gazette (*Darzhaven vestnik*) and in at least two national daily newspapers the place and time for the tender for the sale of assets under the procedures of previous sentence not later than one month prior to the date of the tender.

The bondholders of any issue of mortgage-backed bonds of a bank which has been declared bankrupt shall have the right to obligate the Trustee to sell loans included in the issue cover to a buyer specified by them and the Trustee shall follow precisely the decision of the Bondholders' General Meeting under the previous sentence.

The liabilities of the issuing bank under a mortgage-backed bonds issue shall be deemed repaid when the amount of outstanding principals of the sold loans becomes equal to the total amount of liabilities on principals and interest accrued on the bonds prior to the sales.

IX. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

Risk weighting

Criteria for exposures secured by mortgages on immovable property are treated in Article 27 of Ordinance No. 7 of 24 April 2014 on organisation and risk management of banks[2], adopted by the Bulgarian National Bank ("Ordinance 7"). This Ordinance shall put into force the provisions of Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC.

The Ordinance contains provisions related to the exercise of national discretions by the Republic of Bulgaria under Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms ("Regulation (EU) No 575/2013")[3]. Article 27(1) of Ordinance 7 states as regards the application of Article 124, paragraph 2 of Regulation (EU) No 575/2013:

1. Part of the exposure secured by mortgages on residential property that receives a risk weight of 35% shall not exceed 70% of the lower of the market and mortgage lending value of the property in question;
2. Part of the exposure secured by mortgages on commercial immovable property that receives a risk weight of 50% shall not exceed 50% of the lower of the market and mortgage lending value of the property in question.

For the purposes of updating the ratios under paragraph 1 above, banks shall submit data required under Article 101 of Regulation (EC) No 575/2013 and in Annex VI and Annex VII of the Implementing technical standard for supervisory reporting, taking into account the percentages under paragraph 1 above.

According to Article 29. (1) of Ordinance 7 which refers to Article 400, paragraph 2 of Regulation (EU) No 575/2013 in calculation of large exposures under Article 395 of Regulation (EU) No 575/2013, banks shall exempt the exposures in covered bonds falling within the scope of Article 129, paragraphs 1, 3 and 5 of Regulation (EU) No 575/2013.

Compliance with European Legislation

Mortgage-backed Bonds Law is compliant with the requirements of Art.52 par.4 UCITS Directive. The legislation when taken together with the practices, processes and procedures across the industry should fall within the criteria of Article 129 of the Capital Requirements Regulation (CRR).[4]

[2] Published in the Darjaven Vestnik (State Gazette), Issue 40 of 13 May 2014;
http://www.bnb.bg/bnbweb/groups/public/documents/bnb_law/regulations_risk_management_en.pdf.

[3] Amending Regulation (EU) No 648/2012 (OJ, L 176/1 of 27 June 2013), including the transitional provisions under Part Ten, Title I of Regulation (EU) No 575/2013 and supplemented by Commission Delegated Regulation (EU) No 523/2014 of 12 March 2014.

[4] Please click on the following link for further information on the UCITS Directive and the Capital Requirements Regulation (CRR):
http://ecbc.hypo.org/Content/default.asp?PageID=504#position.

X. ADDITIONAL INFORMATION

Minimum information requirements for issuance prospectuses

The offering or the draft prospectus for an issue of mortgage-backed bonds consists of data valid at the time of their preparation, such as:

> The Rules of the issuing bank concerning the contents, the entry and deletion procedures as well as the terms and procedures authorizing access to the register and its internal rules of conducting and documenting mortgage appraisals;

> Data on mortgage loans held in the issuing bank's portfolio on the basis of which an issue is being made, including for each loan:

a) The size of the outstanding principal at the time of extending the loan and by the end of the most recent full quarter;

b) Loan life at the time of extending the loan and the remaining term to maturity;

c) Interest rates, fees and commissions on the loan;

d) Risk classification of the loan by the end of each calendar year from the time it was extended and by the end of the most recent full quarter;

e) Type of real estate mortgaged as collateral, their mortgage appraisal value and the ratio between the outstanding principal and the mortgage appraisal value at the time of extending the loan and by the end of the most recent full quarter;

> Characteristics of the mortgage loan portfolio on the basis of which the issue is made, including a distribution of loans by:

a) The size of the outstanding principal;

b) The residual term to the final repayment of the loan;

c) Interest rate level;

d) Their risk classification by the end of the most recent full quarter; and

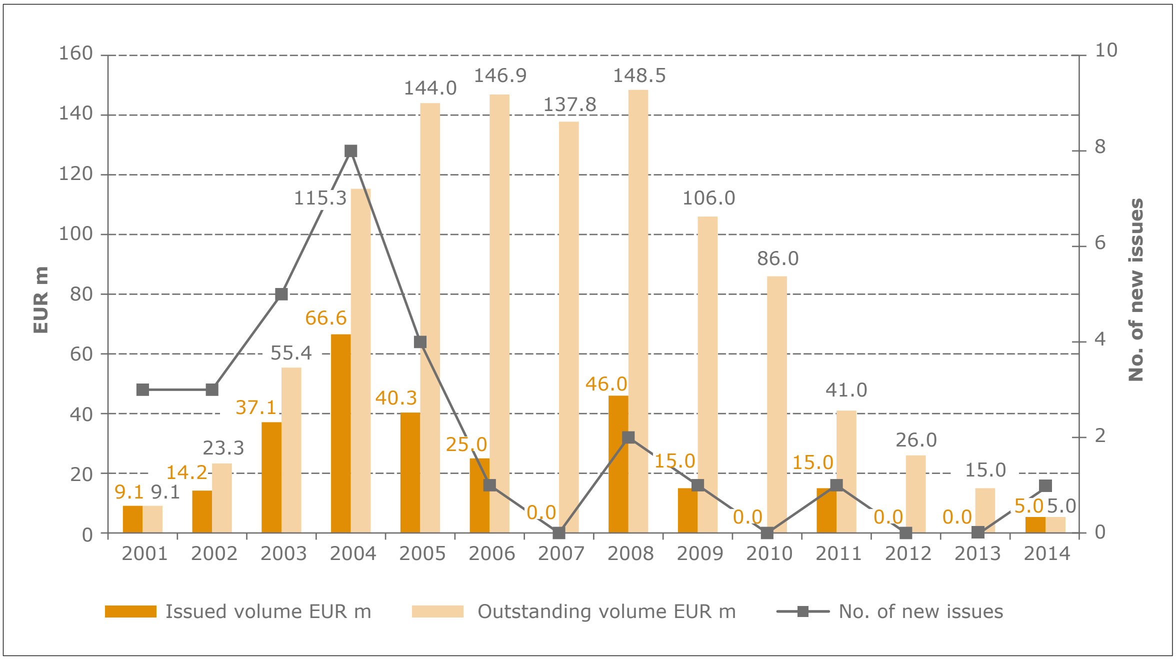
e) The ratio between the outstanding principal and the most recent mortgage appraisal value of the real estate pledged as collateral.

In public offerings of mortgage-backed bonds the provisions of the Public Offering of Securities Act (POSA) and the Ordinances on its enactment shall apply. In non-public offerings of mortgage-backed bonds the provisions of Commerce Law shall apply.

Bulgarian mortgage bond market information

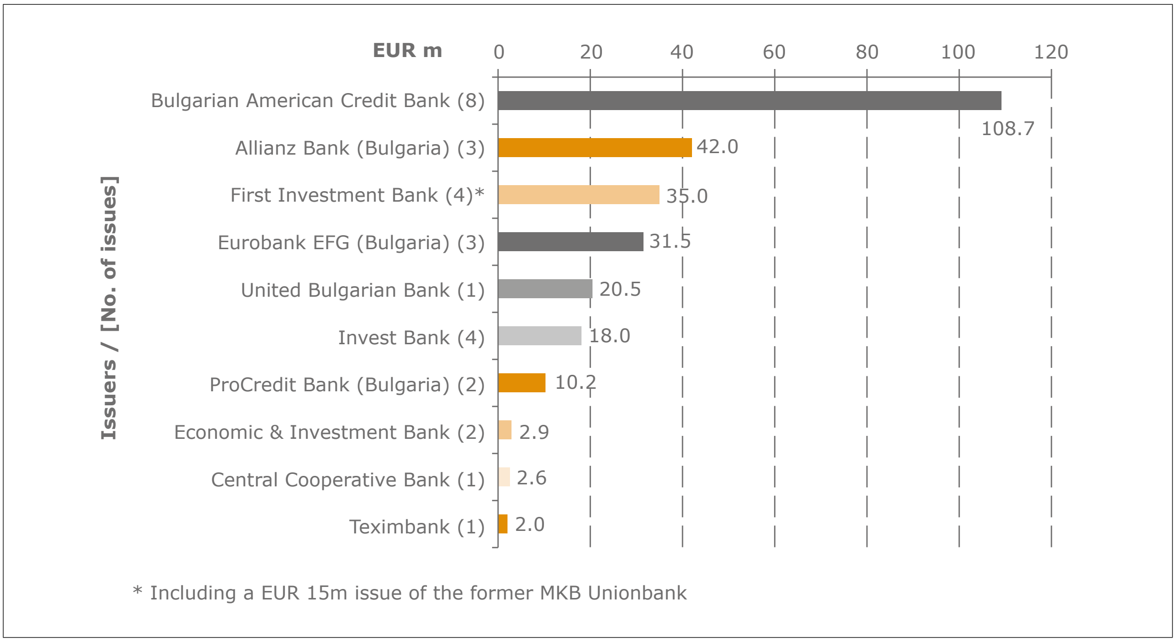
Since the adoption of the Bulgarian Law on Mortgage-backed Bonds in 2000 the mortgage bond issues in Bulgaria total 29. In 2014 one mortgage bond was issued. The volume of issued mortgage-backed bonds totals EUR 273.3 m originated by 11 issuing banks (currently 10 banks after the merger of MKB Unionbank and First Investment Bank). As of 31 December 2014 the outstanding mortgage bonds amounted to EUR 5.0 m.

> Figure 1: Mortgage Bond Issues in Bulgaria, 2001-2014



Source: Bulgarian Central Depository

> Figure 2: Mortgage Bond Issuers in Bulgaria, 2001-2014



Source: Bulgarian Central Depository

ECBC Covered Bond Comparative Database: http://ecbc.eu/framework/72/Bulgaria.

3.5 CANADA

Prepared by Canada Mortgage and Housing Corporation

I. FRAMEWORK

From 2007 until 2012, Canadian covered bonds were issued pursuant to a contractual framework. In June 2012, Canada implemented dedicated covered bond legislation with the amendment of the National Housing Act[1], making Canada Mortgage and Housing Corporation (CMHC) responsible for administering the legal framework for covered bonds. In December 2012, CMHC implemented the legal framework and published the Canadian Registered Covered Bond Programmes Guide (CMHC Guide) which prescribes detailed requirements for registered issuers and programmes.[2] The NHA and the CMHC Guide together form the legal framework for Canadian registered covered bonds. The legal framework provides statutory protection for covered bond investors, prescribes eligible issuers, programmes and cover pool collateral, and establishes a high standard of disclosure.

Since 2013, new covered bond issuance is restricted to "registered" covered bonds issued under the legal framework. To be able to issue covered bonds, issuers must submit applications to CMHC to obtain registered issuer and registered programme status. Issuers and programmes that meet the minimum requirements and are approved by CMHC are added to the Canadian Covered Bonds Registry maintained by CMHC. CMHC has the power to suspend a registered issuer's right to issue further registered covered bonds.

Contractual or non-registered covered bonds issued between 2007 and 2012 ("Historical Bonds" in the CMHC guide) that are not registered under the legal framework will remain managed in separate programmes and amortise gradually until February 2019. For information on Canadian "contractual" covered bonds please see the 2012 ECBC European Covered Bond Fact Book.

Under the new legal framework, eligible collateral consists of Canadian residential mortgage loans that are not insured against borrower default. Mortgages which are insured against borrower default are not permitted to be held as collateral. The Government of Canada and CMHC do not provide any guarantees or backing for covered bond issues.

The covered bond issuance limit of 4% of total assets, which was put in place in June 2007 by the Office of the Superintendent of Financial Institutions (OSFI), is unchanged. OSFI regulates Canadian federally incorporated financial institutions (including all of the current Canadian covered bond issuers except for one provincial issuer which is regulated by the Autorité des marchés financiers (AMF)). Details below are related to Canadian registered covered bonds issued by registered issuers under the legal framework.

II. STRUCTURE OF THE ISSUER

Only banks, trust and loan companies, cooperative credit associations and insurance companies in Canada are eligible to register as issuers under the Canadian covered bonds legislative framework with the approval of CMHC. CMHC's approval is contingent upon fulfilment of minimum legal requirements set out in the CMHC Covered Bonds Guide. The framework requires at least two rating agencies to provide ratings based on their assessment of the issuer and the covered bond transaction. The CMHC may suspend the right of issuing "registered" covered bonds in case of a breach of legal requirements that are not remedied. The seven covered bond "registered" programmes are: Canadian Imperial Bank of Commerce, Royal Bank of Canada, Bank of Nova Scotia, National Bank of Canada, La Caisse Centrale Desjardins, Bank of Montreal and Toronto Dominion Bank.

[1] See National Housing Act R.S.C., 1985, c. N-11.

[2] See CMHC's Canadian Registered Covered Bond Programs Guide (www.cmhc-schl.gc.ca).

Canadian registered covered bonds are direct obligations of the issuer. In addition, in the event of issuer insolvency or default, investors have a claim over the pool of cover assets. The cover assets are held in a bankruptcy-remote special-purpose entity, the guarantor, which provides an irrevocable guarantee in respect of interest and principal payments due and payable under the covered bonds that would otherwise be unpaid by the respective issuer. In Canada, the guarantor may be set up as a limited liability partnership (LLP) or a trust. To date, all registered programs have used an LLP. A bond trustee (which has to be arm's length and bankruptcy remote from the issuer) must be designated to represent the views and interests (and enforce the rights) of covered bond holders.

Cover assets are segregated from the issuer through a contractual sale of the mortgage loans to the guarantor entity. However, registered legal title to the mortgage collateral typically remains with the issuer or lender from which they are purchased by the guarantor until the earliest to occur of: (1) material breach or default by the issuer; (2) impending or actual issuer insolvency; (3) material breach or default by the servicer of eligible loans; or (4) any other event as prescribed in the issuer's transaction documents. Each registered issuer must engage an arm's length bankruptcy-remote custodian with appropriate systems and knowledge of handling mortgages. The issuer must provide the custodian with the details of eligible and substitute assets, and quarterly updates thereof.

III. COVER ASSETS

Eligible assets for Canadian registered covered bonds are:

> Canadian residential mortgage loans on properties with 1-4 units with a maximum LTV of 80% that are not insured against borrower default; and

> Substitute assets up to the prescribed limit (10%).

Eligible mortgage loans must be secured by residential mortgages on properties (of no more than four residential units) located in Canada. These must be uninsured against borrower default, first ranking and with a maximum 80% loan-to-value. Additional eligibility criteria include: no arrears, at least one payment made (of principal or interest), and no loans under dispute/setoff. Loans must be originated by the issuer and/or comply with its underwriting policies. Only eligible loans may be transferred to the guarantor. Any loan that did not meet the eligibility requirements at the time of transfer must be repurchased by the issuer.

Substitute assets can be included in the cover pool but cannot exceed 10% of the total value of the cover pool assets. They must be Canadian government bonds or any other prescribed assets. The guarantor may also hold cash of a total amount not exceeding its payment obligations in the next six months.

The Government of Canada and CMHC do not provide any guarantees or backing for covered bond issues.

IV. VALUATION AND LTV CRITERIA

As noted above, the maximum LTV at the time of transfer of a loan to the guarantor is 80%. In Canada, prudential regulators require property values to be assessed during the underwriting process prior to making a mortgage loan. Property valuation is either performed by an accredited third-party property appraiser or an independently maintained valuation/risking model is used to assess the stated property value based on similar properties recently sold in the same area.

Under the covered bonds legal framework, loans are included in the cover pool coverage calculations up to the 80% LTV cap. Effective July 1, 2014, property values must be indexed at least on a quarterly basis for the purposes of valuing the covered bond collateral. The indexation methodology for a covered bond programme is disclosed to investors in the covered bond programme prospectus and must be in line with any regulatory requirement.

V. ASSET – LIABILITY MANAGEMENT

Within covered bond programmes, there is an inherent liquidity mismatch due to the bullet payment nature of the covered bonds and the cash flows generated from the cover assets. Following a default by the issuer, the principal cash flows generated from the cover assets may not be sufficient to ensure timely repayment of the outstanding covered bonds. To mitigate this credit and liquidity risk, the covered bond framework requires contractual minimum and maximum over-collateralisation (OC) amounts to be specified in the transaction documents. Registered issuers must establish a minimum and maximum OC level in their respective covered bond programmes. The minimum OC will be one of the key factors considered by rating agencies and varies from 3.1% to 7.5% for the Canadian programmes. The maximum OC limit eliminates uncertainty regarding available OC to covered bond holders.

Furthermore, the issuer is required to put in place covered bond collateral hedges (if not there already) for the guarantor at the time of each transfer of covered bond collateral or covered bond issue in order to minimise interest rate or FX mismatches which may include contingent covered bond collateral hedges, which become effective, e.g., in case of an event of default of the registered issuer. The guarantor carries out monthly valuations to assess market risks[3]. Hedging counterparties must meet the counterparty requirements set out in the CMHC Guide, including minimum standards established by rating agencies. The terms of each transaction document must explicitly state that the guarantor may replace a specific counterparty upon rating triggers or in case of an event of default of the registered issuer. CMHC must be informed of counterparty replacement, termination or resignation. Swap counterparties rank pari passu with covered bondholders prior to issuer default.

The framework requires a ratings trigger for the establishment of a cash reserve for the benefit of the guarantor sufficient to meet in full all interest payments due on outstanding covered bonds together with all payment obligations of the guarantor entity ranking prior to such interest payments. It is retained in a bank account and, following an issuer event of default, the balance of the cash reserve forms part of available revenue receipts to be used by the guarantor to meet its obligations under the covered bond guarantee.

Typical of SPV structures, Canadian issuers must meet the following tests on a monthly basis:

> Asset Coverage Test (ACT): The ACT determines whether the issuer meets the pre-determined minimum and maximum OC levels. An asset monitor also tests the accuracy of the ACT calculation yearly, or more frequently under specific circumstances.

> Pre-Maturity Test (PMT): At programme specific ratings triggers, the PMT ensures that the covered bond collateral includes sufficient cash to meet in full all principal payments due under all outstanding covered bonds (together with all other payment obligations ranking in priority) for a period prescribed in the transaction documents of the specific programme.

> Amortisation Test (AT): Following an issuer event of default, the AT ensures that the notional value of cover assets is at least equal to the outstanding Canadian Dollar equivalent covered bonds principal.

VI. TRANSPARENCY

The Canadian covered bond legal framework is prescriptive in terms of information disclosure and reporting. The requirements are comprehensive and include the following:

> All material information related to a registered issuer and covered bond programme must be accessible on an ongoing basis, mainly through a dedicated website set up by the issuer. All transaction documents must be available on the website.

[3] This measures the present value of the covered bond collateral versus the market value of the outstanding covered bonds (in Canadian dollars).

> A monthly report must be prepared within 15 business days of the end of each month and include detailed information on the covered bond programme (e.g. key parties/counterparties, ratings, event of default occurrence, credit enhancement and rating triggers, statistics related to cover asset and covered bonds, material issues and deficiencies).

VII. COVER POOL MONITOR AND BANKING SUPERVISION

CMHC is responsible for administering the Canadian covered bonds legal framework. Only eligible federally and provincially regulated financial institutions that meet the requirements of the legal framework can issue registered covered bonds. In Canada, federal financial institutions are prudentially regulated by OSFI. Provincial financial institutions are subject to prudential regulation by the respective provincial entity.

Issuers are required to appoint an independent third party cover pool monitor (CPM) with adequate qualifications. The responsibilities of the CPM consist of ensuring the accuracy of the records regarding the cover pool and the adequacy of the required tests. Results should be reported to the CMHC and the bond trustee annually or whenever deemed reasonable. Issuers should make available all information needed by the CPM. Following issuer insolvency, the CPM remains in place for the benefit of the guarantor. "Registered" issuers must provide immediate notice to the CMHC in case of: (1) a failed ACT and/or AT; (2) awareness of a rating downgrade/ withdrawal/trigger; (3) a breach or default under the terms of the covered bond programme; and (4) breach or default under the covered bonds legal framework.

VIII. SEGREGATION OF COVER ASSETS AND BANKRUPTCY REMOTENESS OF COVERED BONDS

The guarantor is structured as a bankruptcy-remote, special-purpose entity and, as such, following insolvency of the issuer, all the assets of the guarantor are segregated from those of the bankrupt estate of the issuer.

> Upon an issuer event of default, the guarantor is required to meet the covered bond obligations using the cash flows generated from the cover assets. In case of insufficient cash, the guarantor is permitted to sell the cover assets, find alternative funding or enter repos. The entire pool of cover assets is available as security for all the outstanding covered bonds issued under the programme, so there is no direct link between particular assets and a specific series of covered bonds.

> Upon a guarantor event of default, covered bonds accelerate. Preferential rights are limited to the guarantor's assets, although, if cover assets are insufficient, covered bond holders have recourse to the assets of the issuing entity ranking pari passu with ordinary depositors and unsecured debt holders. Payments are made in accordance with the applicable order of priority.

An issuer or guarantor event of default include at a minimum (other events maybe prescribed in the documentation) the following: (1) impending or actual insolvency; (2) failure to pay principal, interest or any other amount due under the covered bond programme when due; (3) failure to comply with the remedial action following a rating trigger; and (4) failure to meet the AT by a guarantor on a calculation date. An issuer's transaction documents can provide a remedy period of up to 10 business days for a failure to pay principal, and up to 30 days for failure to pay interest or other payment under the covered bonds.

IX. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

Canadian covered bonds are eligible to be used as liquid assets (Level 2A) under the European Union's implementation of the Basel liquidity coverage ratio requirements. Canadian covered bonds are not UCITS 52(4)-compliant or CRR-compliant as Canadian issuers do not have their registered head office in an EU state.[4] Therefore, they do not benefit from a preferred risk-weighting for regulatory capital purposes. Under the Standardised

[4] Please click on the following link for further information on the UCITS Directive and the Capital Requirements Regulation (CRR): http://ecbc.hypo.org/Content/default.asp?PageID=504#position.

Approach, they are treated similarly to senior unsecured bank debt. That said, if denominated in €/£/¥/US$, Canadian covered bonds are eligible for European Central Bank repo operations, conditional on an investment-grade rating. Specific haircuts are applied depending on the rating and characteristics of the covered bond.

X. ADDITIONAL INFORMATION

X.1. Eligible for Level 2A assets of Basel's Liquidity Coverage Ratio (LCR)

In November 2014, OSFI reconfirmed the eligibility of covered bonds for the LCR as part of the Level 2A high quality assets. Eligible covered bonds must meet the following criteria:

> Not issued by the institution itself or any of its affiliated entities;

> With a minimum AA- rating and a proven record as a reliable source of liquidity in the markets (repo or sale) even during stressed market conditions: i.e. maximum decline of price or increase in haircut over a 30-day period during a relevant period of significant liquidity stress not exceeding 10%;

> Traded in large, deep and active repo or cash markets characterised by a low level of concentration.

"Historical" covered bonds issued by Canadian institutions prior to the Canadian covered bond legislation coming into force on July 6, 2012 may be included as Level 2A assets if they meet the above requirements non-related to the law.

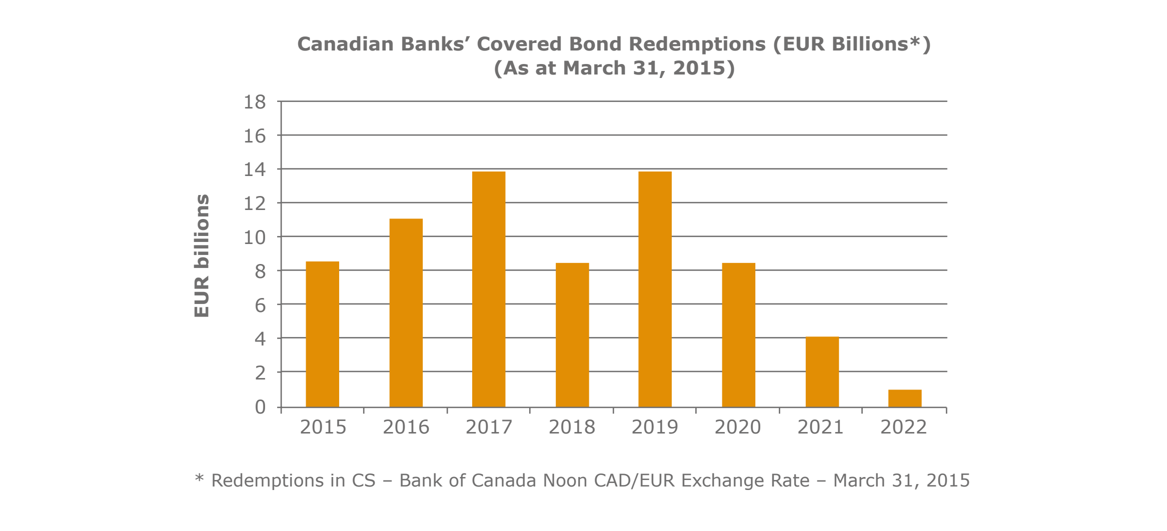
X.2. Canadian banks issuance capacity after re-start

In 2012-2013, covered bond issuance by Canadian banks decreased as they could no longer issue under their "historical" programmes and had to set up new "registered" ones. Issuance resumed during the summer 2013 and has been rather active since, with all seven covered bond issuers having issued under their programmes. Canadian banks remain key participants in international covered bond markets, issuing in the CAN$, €, US$ and AU$ markets due to favourable basis swaps and strong market technicals (see "Other currencies in the Generic Section for more details). Canadian banks' constraint in terms of future issuance is the 4% limit of total assets and not the amount of eligible collateral. Based on recent data, Canadian banks have enough uninsured mortgages on their balance sheets to issue further covered bonds. The remaining capacity for the banks is about C$81 (gross) as on March 31, 2015 (see Figure 1 below). Redemptions especially of "historical" covered bonds, which are spread over the next few years, should also support new issuance (see Figure 2 below).

Figure 1: Canadian Banks' Covered Bond Issuance

At 31 May 2015 (C$ bn)	BMO	BNS	CCDJ	CIBC	NBC	RBC	TD	Total
OSFI covered bond issuance limit	24.5	33.9	6.8	17.4	8.3	43.5	41.0	175.4
Outstanding covered bonds	9.8	17.6	5.5	10.9	6.4	27.7	16.5	94.4
- non-registered	5.6	9.0	2.5	5.3	2.0	0.0	8.0	32.4
- registered	4.2	8.6	3.0	5.6	4.4	27.7	8.5	62.0
Remaining issuance capacity	**14.7**	**16.3**	**1.3**	**6.5**	**1.9**	**15.8**	**24.5**	**81.0**

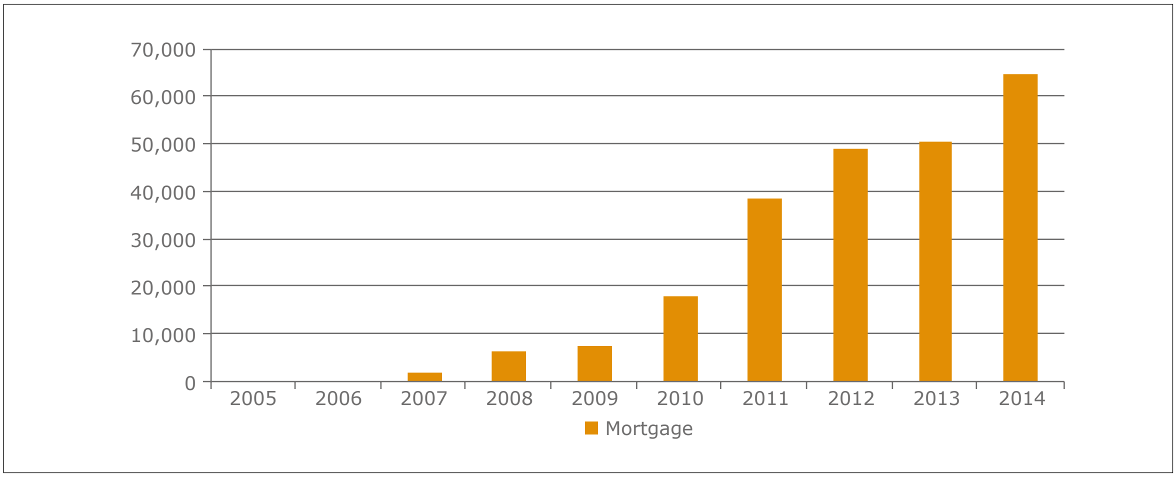
> Figure 2: Canadian Banks’ Covered Bond Redemptions (as on 31 March 2015, EUR bn)



* Redemptions in CS – Bank of Canada Noon CAD/EUR Exchange Rate – March 31, 2015

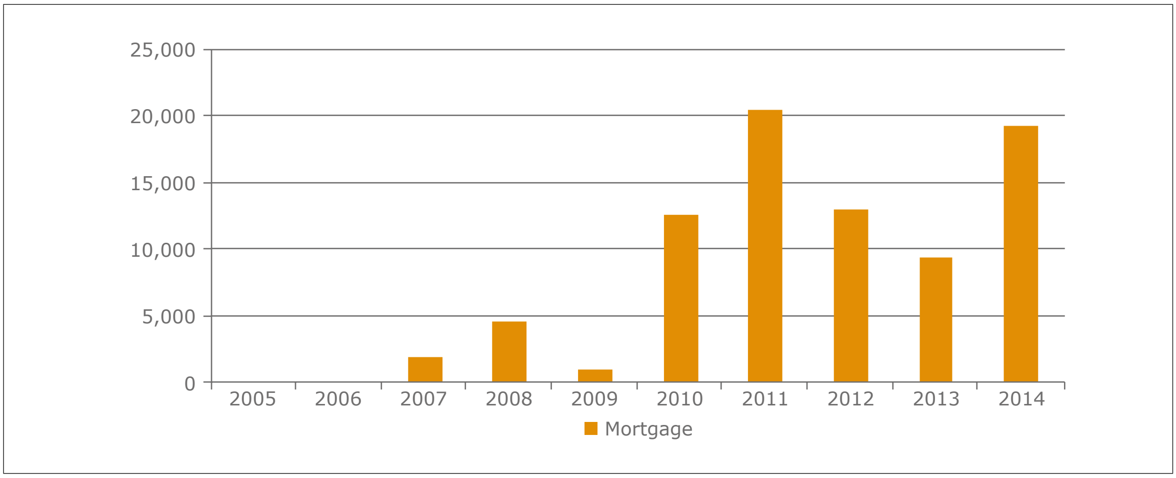
Source: CMHC

> Figure 3: Covered Bonds Outstanding, 2005-2014, EUR m



Source: EMF-ECBC

> Figure 4: Covered Bonds Issuance, 2005-2014, EUR m



Source: EMF-ECBC

Issuers: Royal Bank of Canada (RBC), Bank of Montreal (BMO), Bank of Nova Scotia (BNS), Canadian Imperial Bank of Commerce (CIBC), Caisse Centrale Desjardins (CCDJ), National Bank of Canada (NBC), Toronto Dominion Bank (TD).

ECBC Covered Bond Comparative Database: http://www.ecbc.eu/framework/12/Canadian_Covered_Bonds.

3.6 CHILE

By Antonio Procopio, Emiliano Muratore and Patricia Perez, Banco Santander Chile

I. FRAMEWORK

The legal framework for Chilean covered bonds (Bonos Hipotecarios, also BHs) is determined by:

> The General Banking Law (Ley General de Bancos, LGB): Article 69, n°2, BH issuances; and Articles 125, 126 and 134, special treatment of banking entities under bankruptcy.

> The Chilean Central Bank: Financial Regulation Compendium (*Compendio de Normas Financieras*, CNF), Chapter II.A.2, Chilean Central Bank complementary rules.

> Superintendency of Banks (*Superintendencia de Bancos e Instituciones Financieras*, SBIF): *Recopilación Actualizada de Normas* (RAN), Chapter 9-2, Complementary rules of the Chilean banking regulatory agency.

In 2010, Law 20.448 – also called MKIII, the third reform to the Capital Markets Law — introduced a series of changes in terms of liquidity, financial innovation and integration of the capital markets. Among them was the amendment of Article 69, n°2 of the LGB which enabled banks to issue bonds with no special guarantees, called BHs. These securities are specifically aimed to raise funds for the origination of mortgage loans (*mutuos hipotecarios*) used to finance the acquisition, construction, repair or extension of residential properties. Only residential mortgages for these purposes are accepted as collateral, excluding commercial, public or other types of loans. An additional restriction imposed to define an eligible mortgage is that only new mortgages are accepted. Hence, a maximum time limit of 18 months was set for the origination of eligible loans since the date of the BH's issuance. Thus, BH bonds also have an anticipated rescue clause for a proportional prepayment of the bond in case of insufficient origination. The issuer has the flexibility of an additional one month period to incorporate new mortgage loans of the same nature and quality to comply with the cover asset limit and balance principle at the end of this 18 months allocation period and at the end of each month along the life of the bond.

Under an eventual credit event/default of an issuer, Articles 125, 126 and 134 of the LGB give BHs the same treatment and current legal status as that of outstanding *Letras Hipotecarias* (LH), a type of mortgage bond frequently used by Chilean banks in the past to finance their mortgage business. These articles regulate the procedures in such case and the mechanisms for the tender process and subsequent transference of eligible loans/assets and liabilities from the defaulted issuer to a new entity.

In September 2012, the final regulation was published in a joint statement by the Chilean Central Bank and the SBIF, describing BHs as a new source of long term funding for banking entities, thus allowing better conditions for clients as well as a new investment alternative for institutional investors. At the same time it explicitly incorporated a prudential regulation associated with financial stability objectives. In particular it stated the obligation of periodic reporting of both bonds and loans, the definition of certain credit indicator limits, specific policies to grant loans and other transparency objectives for the benefit of both clients and investors.

Chapter II.A.2 of the CNF regulates issues related with eligible loans, as well as investments in fixed income securities as substitute collateral since the date of issuance during the period of loan origination, specifying limits for compliance during the whole life of the bond.

The SBIF's RAN mainly regulates the issuance of BHs, the relationship between bonds and loans, and the establishment of a special Register for further control which includes detailed up-to-date information to comply with transparency and monthly reporting objectives.

II. STRUCTURE OF THE ISSUER

Under current legislation only banking entities are allowed to issue Bonos Hipotecarios. Cover assets are held within the balance sheet with the proper internal controls to monitor the cover pool and its relationship with its related bond ratios and limits over time.

Banco Santander Chile issued the first ever local covered bond (Bono Hipotecario). The first covered bond program was for a total amount of UF 3 Million (aprox. USD 134 million), the first issuance out of the program was in August 1st, 2013 for a total amount of UF 1.5 MM (aprox. USD 68 million) and then the second one was in November 20th, 2013. Both issuances generated a great appetite from local investors and the result was a spread of 15 bps lower than the senior unsecured debt outstanding. Currently, Banco Santander Chile is in the process of registering the second covered bond program for a total amount of UF 5 Million (aprox. USD 220 million).

III. COVER ASSETS

Regulation states that issuers have 18 months since the bond's date of issuance to allocate the resources to the origination of mortgages. After that period, at the end of each month during the life of the BH, the outstanding balance of mortgages, excluding amounts in arrears, should not be lower than 90% of the outstanding balance of the respective bonds. Any difference between the outstanding amounts of the mortgages and the bonds must be covered by high credit quality fixed income instruments.

Figure 1: Fixed income substitute collateral: minimum 80% in sovereign bonds (Categories: I. and II.)

I.	Sovereing bonds	Fixed income instruments issued by Chilean central bank.
II.	Sovereing bonds	Fixed income instruments issued by Chilean treasury.
III.	Corporate bonds	Local high rated corporate bonds. Sub limit of up to 10% of the total of funds by each *Bono Hipotecario* issuance.
IV.	Bonos Hipotecarios	*Bonos Hipotecarios* issued by other banking entities.
V.	Term deposits	Term deposits originated by high rated banks established in Chile, excluding those of the issuer of the covered bonds.
VI.	LCH	Housing LH: *Letras De Crédito Hipotecario* issued for housing purposes by other banking entities.
VII.	Unsecured bank bonds	Unsecured bank bonds rated AA+ or higher, excluding those of own issuance.

Source: Chilean Central Bank, Banco Santander Chile

IV. VALUATION AND LTV CRITERIA

Eligible loans are only accepted as collateral for the corresponding issued bond once the accredited third-party property appraiser has finished the valuation process and, after it has been registered at the corresponding CBR (*Conservador de Bienes Raices*) – the local entities that certify legal dominion of properties.

The minimum loan-to-value (LTV) defined by law is 80%. Conditions for valuation are also subject to performing or non-performing status of loans. The maximum accepted number of arrears of any single loan in the pool is 10. Above that, the loan must be replaced with a new one of the same nature. As explained before for the cover-to-bond outstanding balance ratio all amounts in arrears are excluded.

LTV alone is not enough for eligibility of mortgage loans. In addition a maximum debt-to-income ratio of 25% is demanded.

V. ASSET – LIABILITY MANAGEMENT

Current legislation does not prescribe over-collateralization for the issuance of BHs.

Under a balance principle the nominal amount of cover assets must always be at least equal to the outstanding amount of related *Bonos Hipotecarios* and loans in arrears or prepaid should be replaced always under the restriction that only new mortgages are potentially eligible as collateral for BHs.

Banks are free to structure the covered bonds according to their own needs and criteria. Banco Santander's first program bond was a 15 year amortizing structure reflecting the expected amortization schedule of the underlying loan portfolio adjusted by the empirical loan prepayment rate. The second bond program will be a 18 years amortizing structure reflecting the expected amortization schedule and the empirical prepayment rate of the new loan portfolio.

VI. TRANSPARENCY

Current regulation includes a prudential approach associated with financial stability objectives: mandatory monthly reports of assets and liabilities in the Register and compliance of required ratios; a specific Credit Policy for mortgage eligibility which must be approved by the Board of Directors and published on the issuer's webpage; and client's LTV and debt-to-income ratios reported in a monthly basis.

VII. COVER POOL MONITOR AND BANKING SUPERVISION

Article 69, n°2 of the LGB mandates banks to maintain a special mortgage register (*Registro de Mutuos Hipotecarios*) for the identification and control of the relation between mortgages and their respective BH issuances.

SBIF's RAN 9.2, n°5, sets conditions for inscription of mortgages on the Register and the required information including: identification of bond issuance and loans; dates of inscriptions; original and substitute loans; identification of fixed income assets held as substitute collateral; and elimination from the register by number of arrears or property value deterioration.

Central Bank's CNF Chapter II.A.2, n°18, within its explicit transparency and information objectives, details monthly reporting data including: up-to-date average debt-to-income ratios of clients with eligible loans for each series of BH issuances; average value of properties linked to BHs at the date the credit was granted; LTV of the pool updated by loan replacements; loan characteristics (maturity, interest rates, fixed, floating or mixed type, currency denomination, inflation link mechanism and loan prepayment conditions); outstanding balances of loan portfolios and associated BH issuances and, finally, the total amount of fixed income assets and its general characteristics.

VIII. SEGREGATION OF COVER ASSETS AND BANKRUPTCY REMOTENESS OF COVERED BONDS

There are 2 main issues related with bankruptcy in the BH legislation:

1) Since only new loans are accepted as collateral this avoids the possibility of structuring BHs with a selection of the best quality assets which could be against the interests of other creditors such as depositors in case of bankruptcy.

2) In the case of bankruptcy a special procedure in the way of a separated auction or tender process is triggered for those assets and liabilities clearly identified and associated with BHs in the Register. Eligible bidders are other public or private financial institutions, and the final buyer must take care of BH payments. This process, the same as for Letras de Crédito Hipotecarias (LH) is thoroughly covered in the LGB.

IX. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

Chile is not a member of the European Union. Therefore, and although Chilean BHs will be issued under the existence of a specific country legislation – which is a requirement for these matters – no special treatment or benefit is expected in terms of preferred risk-weighting for regulatory capital purposes.

X. ADDITIONAL INFORMATION

In a clear intent to provide these Bonds with more liquidity the Chilean Central Bank announced on 28 March 2013 a special Repo program (“Repo BH”) which will accept exclusively BHs as collateral. The Repo BH will be offered for up to 14 days at a floating rate equivalent to the current monetary policy rate (MPR) of each day plus 25 basis points. Eligible BHs will be subject to the credit rating of the BH issuer banking entity which must be in AAA, AA or A.

3.7 CYPRUS

By Ioannis Georgiou, Bank of Cyprus

I. FRAMEWORK

The primary legislation governing the issuance of covered bonds (Kalimmena Axiografa) is the Covered Bond Law of 2010, (130 (I)/2010), which came into force on December 23, 2010 (the "Law").

On the same day, the CBC issued a Directive (526/2010) under the provisions of the Law, which constitutes the regulatory framework for the issue of covered bonds (the "Directive").

The Law and the Directive (the "Cypriot Legal Framework") are further supplemented by other laws (e.g. the Bankruptcy Law, the Banking Business Law, the Companies Law etc.) as referenced by the Law.

The Cypriot Legal Framework has been finalized in consultation with and following the positive opinion of the ECB, dated 14 October 2010 and 23 March 2011 related links are: http://www.ecb.int/ecb/legal/pdf/en_con_2011_27_f_sign.pdf and http://www.ecb.int/ecb/legal/pdf/en_con_2010_73__f_sign.pdf).

II. STRUCTURE OF THE ISSUER

Under the Cypriot Legal Framework, Credit Institutions which have been approved by the Competent Authority (i.e. the CBC or the CSSDA), are only allowed to issue covered bonds using the direct issuance route.

Credit Institutions are defined, under the Law, to be:

> Banks (as defined in the Banking Laws);

> Cooperative Credit Institutions (as defined in the Cooperative Societies Law); and

> The Housing Finance Corporation (established under the Housing Finance Corporation Laws).

In accordance with Parts II and III of the Law, only Approved Institutions are eligible to issue covered bonds. Approved Institutions, are those Cypriot Credit Institutions which have been registered in the Register of Approved Institutions, (publicly available at the following link: http://www.centralbank.gov.cy/media/xls/ENG_2_Register_of_Approved_Inst.xls) following a relevant application to the Competent Authority.

Approval of such application is granted within 1 month from submission, and only after the Credit Institution has successfully demonstrated its ability to carry out the legal obligations of an Approved Institution, and that it fulfills the criteria and conditions determined by the Competent Authority.

Indicative minimum requirements set out in the Directive, for the registration of a Credit Institution in the Register of Approved Institutions, are:

> Core Tier 1 capital of at least EUR 50 million and capital adequacy ratio as required by the CBC under Pillar I and Pillar II of Regulation 575/2013 (Capital Requirements Regulation);

> Establishment of an automated system for the support of the covered bonds business;

> Established risk management procedures for the recognition, management, monitoring and control of risks that may arise during the conduct of the covered bonds business;

> Procedures, policies and systems in place for the support of the covered bonds business; and

> Compliance with the provisions of the Law and the Directive, to be represented by a written confirmation by the Board of Directors of the Credit Institution.

With respect to individual covered bond issuance, Approved Institutions must subsequently apply to the Competent Authority for registration of such new issue in the Covered Bonds Register (publicly available at the following link: http://www.centralbank.gov.cy/nqcontent.cfm?a_id=11439&tt=article&lang=en). Approval of such application is granted within 10 days from submission, and it is only following such approval that a newly issued bond becomes a covered bond.

III. COVER ASSETS

Primary cover assets are:

> Residential property backed loans (i.e. any kind of credit facility, secured on immovable property, provided that the property is used or intended to be used for residential purposes;)

> Commercial property backed loans;

> Public claims;

> Maritime loans; and

> Any other type that may be determined by the Competent Authority.

The criteria, terms and conditions in relation to cover assets are determined by the regulator in Articles 13, 14 and 15 of the Directive. The main criteria indicatively include:

> Residential and commercial loans should be secured by a mortgage (or an equivalent security over a property if the property is not located in Cyprus) created in accordance with the Laws of Cyprus or the law of other Member States[1];

> The mortgage or the equivalent charge on immovable property, securing the credit facility, is created for an amount, at least, equal to the value of the loan;

> The immovable property securing the credit facility must be situated on the territory of the Republic or on the territory of other Member States;

> A residential or commercial loan secured by buildings under construction may be included in the cover pool, provided that the total value in each cover pool of the loans secured by buildings under construction does not exceed 10% of the cover pool value;

> Rescheduled loans may be included in the cover pool, only after the lapse of six months from the payment date of the first rescheduled loan instalment;

> Hedging contracts may also be included in the cover pool, only to the extent that they are used exclusively for the purpose of hedging any type of risk that may adversely affect the value of the cover assets.

a) It is noted, that in accordance with Article 33(b) of the Directive, the counterparty in a hedging contract must "*have a credit rating assigned to the first credit quality step as determined in Annex VI of the Directive 2006/48/EC or a guarantee by a connected entity of the counterparty whose credit rating is assigned to the first credit quality step*". The latest version of Annex VI is now incorporated in Article 129 of the Capital Requirements Regulation (CRR).

Finally, apart for the Primary Cover Assets, Complementary Assets may also be included in the cover pool, as prescribed under Articles 16, 17 and 18 of the Directive (e.g. deposits with central banks and other highly rated institutions, traded debt securities, etc.).

Limitations and guidelines on the above are specified in the Directive (e.g. total value of Complementary Assets included in the cover pool and counted in the measurement of the Basic Collateralisation, not to exceed 15% of the total value of covered bonds, etc.).

[1] Member State means a member state of the European Union or other state which is party to the Agreement for the European Economic Area, which was signed in Oporto on 2 May 1992, and adapted by the Protocol signed in Brussels on 17 May 1993.

IV. VALUATION AND LTV CRITERIA

For **residential loans**, the LTV is not allowed to exceed 75%, provided that if the LTV is above 75% but below 100%, such loans may be included in the cover pool on the condition that:

> They do not exceed 25% of the value of the covered bonds secured by the cover pool; and

> Such inclusion would not cause the weighted LTV of the cover pool to exceed 80%.

For **commercial loans**, the LTV is not allowed to exceed 60%, provided that if the LTV is above 60% but below 80%, such loans may be included in the cover pool on the condition that:

> They do not exceed 25% of the value of the covered bonds secured by the cover pool, and

> Such inclusion would not cause the weighted LTV of the cover pool to exceed 65%.

For **maritime loans**, the LTV is not allowed to exceed 60%, provided that if the LTV is above 60% but below 70%, such loans may be included in the cover pool on the condition that:

> They do not exceed 25% of the value of the covered bonds secured by the cover pool, and

> Such inclusion would not cause the weighted LTV of the cover pool to exceed 65%.

In accordance with Article 13(10) and Article 15(10) of the Directive, the valuation of residential and commercial properties and the valuation of ships (Article 15(10) of the Directive) should be carried out by an independent valuer; i.e. a person who possesses the necessary qualifications, ability and experience to produce a valuation and is independent from the credit decision process.

For the monitoring and review of the value of the residential and commercial properties, the provisions of paragraph 8 (b) of Part 2 of Appendix VIII of the Directive of the Central Bank to banks for the Calculation of the Capital Requirements and Large Exposures shall apply. The provisions of the Directive dictate the following:

> The revaluations of the properties may be carried out by applying statistical methodologies.

a) For commercial properties, according to the aforementioned Directive, the value of the property is reviewed regularly and at least once a year;

b) For residential properties, according to the aforementioned Directive, the value of the property is reviewed regularly and at least once every three years; and

c) In situations where the market is subject to significant changes in conditions, a more frequent review of the property value is required.

> When information indicates that the value of the property may have declined materially relative to general market prices, the property valuation must be reviewed by an independent valuer.

> Also when the balance of the financing exceeds €3million or 5% of the own funds of the credit institution, the valuation of the property will be reviewed by an independent valuer at least every 3 years.

Additionally, and pursuant to Article 46(b) of the Directive, the Covered Bond Monitor (“CBM”), appointed in accordance with Article 49 of the Law, has a duty to examine the valuation process in relation to the valuation of the cover assets.

V. ASSETS – LIABILITY MANAGEMENT

The Directive provides for the following statutory tests:

- **Nominal Value Test**

  The adjusted[2] nominal value[3] of the Basic Cover (i.e. the Basic Collateralisation as defined under Article 24 of the Directive) must be at least equal to the total value of covered bonds issued under the programme.

- **Net Present Value Test**

  The adjusted net present value of the Basic Cover must be at least equal to 105% of the total net present value of covered bonds issued under the programme. All cover pool assets, including loans, Complementary Assets and hedging instruments must be included in the calculation of net present value of the Basic Cover.

  The above 105% condition must also be met in the following scenarios:

  (a) Parallel interest rate shift of +200 and -200 basis points;

  (b) Interest rate shifts determined by a 99% 6-month confidence interval using daily changes for the last 365 days;

  (c) Exchange rate changes:

  - Euro and member-state currencies: 10%;
  - Currencies of the United States, Canada, Japan, Switzerland, Australia: 15%; and
  - Other currencies: 25%.

  (d) Exchange rate shifts determined by a 99% 6-month confidence interval using daily changes for the last 365 days.

- **Weighted Average Life Test**

  The weighted average life of cover assets counted in the measurement of Basic Cover and Supervisory Overcollateralisation (as defined under Article 25 of the Directive), must be longer than the weighted average life of the covered bonds.

- **Interest Cover Test**

  Interest inflows from cover pool assets in the Basic Cover and Supervisory Overcollateralisation for the next 180 days must be reconciled with interest due on the covered bonds for the next 180 days and the highest net interest shortfall must be covered by the Complementary Assets contained in the Basic Cover and Supervisory Overcollateralisation.

- **Prematurity Test**

  In relation to the repayment of the principal amount of the covered bonds, liquidity must be maintained, in the form of Complementary Assets or outside the cover pool in the form of liquid assets, as follows:

  a) For the period between 180 days to 30 days before the maturity date of the covered bonds, at least 50% of the principal amount due for repayment;

  b) For the period between 30 days before the maturity date and the maturity date of the covered bonds, 100% of the principal amount due for repayment.

  Liquidity maintained for the purpose of meeting the prematurity test is not subject to the 15% limit of Complementary Assets in the cover pool (set in Article 20 of the Directive).

[2] Adjusted, refers to the set-off and LTV adjustments, as outlined under Article 24 of the Directive.

[3] "Value" is defined under the Directive to mean nominal value plus accrued interest.

Additionally to the above statutory tests, and with a view to protect the depositors and all other unsecured creditors in case of insolvency proceedings, and to potentially provide for a reserve of assets that may be used in the future to sustain further stresses, the Directive provides that an Approved Institution is not permitted to issue covered bonds, if such an issue would result in:

> the total value of the primary assets which are required to be included in the institution's cover pools for each cover bond category, to exceed 90% of total value of the institution's eligible primary assets for that cover bond category, or

> the total value of the cover assets included in all cover pools and counted in the cover pool adequacy, to exceed 25% of the total value of the institution's assets.

VI. TRANSPARENCY

Transparency, in the Cypriot Legal Framework, is ensured through a series of reporting and registers that need to be maintained, updated and monitored by the covered bond Issuers as well as by the Competent Authority.

In accordance with Article 23 of the Law, covered bond Issuers are required to maintain a cover pool register for each covered bond Issue or Programme outstanding. Specific conditions for maintaining such Cover Pool Register (e.g. form, content, entry recording etc.) are outlined in Articles 34-38 of the Directive. The Cover Pool Register is to be updated whenever an asset is included or excluded from the cover pool (and at least on a monthly basis) and shared with the Competent Authority and the CBM.

Specifically, Articles 39-42 of the Directive set further transparency obligations to the covered bond issuers, requiring them to disclose, on a quarterly basis and in a publicly accessible area (e.g. their websites), specific statistical information relating to their outstanding covered bonds, in the form determined therein. The above information is also submitted to the Competent Authority and the CBM on a quarterly basis, in the form of Appendix 5 of the Directive.

With respect to the covered bond issuers and the covered bonds issued and outstanding in Cyprus, transparency is ensured through the maintenance of a Register of Approved Institutions (Article 5 of the Law) as a well as a Covered Bonds Register (Article 12 Law) by the Competent Authority. Both registers are kept in an electronic form and are publicly accessible in the website of the Competent Authority.

VII. COVER POOL MONITOR AND BANKING SUPERVISION

The Cypriot Legal Framework is structured in a manner which ensures very vigilant regulatory supervision of covered bond issuers. In accordance with Article 49 of the Law, each institution applying for registration in the Register of Approved Institutions, is required to appoint a qualified entity (e.g. an audit firm not associated with the covered bond issuer) as a Covered Bond Monitor (the "CBM"), such appointment being subject to the approval of the Competent Authority. The CBM must possess the necessary knowledge, experience and ability for the effective discharge of its functions and have the necessary qualifications outlined in Article 44 of the Directive. To the extent that, for any reason, the covered bond issuer has not managed to appoint a CBM, the Competent Authority is entitled to appoint one.

The duties of the CBM include a broad range of responsibilities, ranging from verifying to the Competent Authority, ahead of the application for the registration of bonds in the Covered Bonds Register, that the institution fulfils the conditions for registration as an approved institution, to submitting information and regular reports to the Competent Authority.

The main responsibilities of the CBM under the Cypriot Legal Framework include:

> Overseeing the compliance of the Issuer with its obligations under the Cypriot covered bond Legislation;

> Prior to an application for the registration of any covered bonds in the Covered Bonds Register, verifying that the Issuer fulfils the conditions for registration as an approved institution and complies with the provisions of the Law in relation to every previous issue of covered bonds that are outstanding;

> Where hedging contracts are included in a cover pool, verifying that these contracts fulfil the criteria set out in Article 26 of the Cypriot covered bond Legislation;

> Monitoring the cover pool assets included in a cover pool, including:

(a) Verifying the accuracy and completeness of the information provided for the cover pool Assets included in the Cover Pool Register;

(b) Examining the valuation process in relation to the valuation of the cover pool assets;

(c) Monitoring compliance, on an on-going basis, with the Statutory Tests; and

(d) Examining the entries in and removals from the Cover Pool Register and confirming the correct recording of the necessary information in the Cover Pool Register.

VIII. SEGREGATION OF COVER ASSETS AND BANKRUPTCY REMOTENESS OF COVERED BONDS

Following the registration of the covered bonds in the Covered Bonds Register, and in accordance with Article 16 of the Law, the cover pool is segregated from the covered bond issuer's insolvency estate, securing the claims of the Cover Pool Creditors[4] and constituting a form of charge over the cover pool assets.

In accordance with the provisions of Article 28 of the Law and Article 21 of the Directive, covered bond issuers are required to maintain a Special Transaction Account, recording all inflows from the cover assets and the outflows from the account together with the details of such outflow. The balance of such Special Transaction Account is to be used solely for the servicing of the covered bonds as well as for the creation or acquisition of cover assets to be included in the cover pool, to ensure fulfillment of the cover pool adequacy criteria.

Furthermore, pursuant to Article 21(3) of the Directive, the covered bond issuer must have procedures in place which ensure, at any time, the ability to trace and calculate the cash inflows from the cover assets that have not been used. The operation of the Special Transaction Account is subject to the supervision of the CBM, in order to ensure that the covered bond issuer complies with the provisions of the Cypriot Legal Framework at all times.

In case of dissolution of the covered bond issuer, and until all legal claims of the Cover Pool Creditors are fully satisfied, the cover pool assets are not available to satisfy the claims of any other creditors of the Issuer in accordance with Article 40(5) of the Law.

By virtue of Article 40(7), 41 and 42 of the Law, the Covered Bond Business Administrator (the "CBBA") is empowered to dispose of the Cover Pool Assets, and use the proceeds of such disposal in order to satisfy the claims of the Cover Pool Creditors in priority over the claims of all other creditors.

To the extent that a covered bond issuer is subject to dissolution proceedings, in accordance with Article 40(5) and Article 40(6) of the Law, until the claims of the Cover Pool Creditors are satisfied in full, the cover pool assets will not be available to satisfy the claims of other creditors. Any surplus from the disposal of the cover pool, and only once the claims of the Cover Pool Creditors have been satisfied in full, shall be returned to the credit institution (Article 44(1) of the Law).

Cover Pool Creditors enjoy a dual recourse, safeguarded under the Law. In accordance with Article 43(5) of the Law, to the extent that the claims of the Cover Pool Creditors are not fully satisfied from the disposal of the cover pool, then these creditors are, with respect to the unsatisfied part of their claims, unsecured creditors of the covered bond issuer.

In addition, where a covered bond Issuer is subject to dissolution proceedings, a Covered Bond Business Administrator (the "CBBA") is appointed by the Competent Authority (as per Article 59(1) of the Law), who

[4] Cover Pool Creditors are defined in Article 2 of the Law to include, inter alia, the Covered Bond holders, the hedge counterparties, the Covered Bond Monitor and the Covered Bond Business Administrator.

takes all necessary measures to assume the control and the management of the cover pool and carries out the covered bond business. Any Cover assets not counted for the purposes of fulfilling the Statutory Tests shall be removed from the cover pool and the Cover Pool Register only by the CBBA.

The treatment of the cover pool following the commencement of dissolution proceedings is summarized below:

- Upon the initiation of dissolution proceedings, the CBBA assumes control of the cover pool (*according to the provisions of Article 40 of the Law*) and also of any liquid assets maintained outside the Register for the purposes of meeting the Prematurity Test, and is responsible to review the adequacy of the cover pool in accordance with Article 19 and Article 23 of the Directive;
- Cover pool adequacy assessment is being performed by the CBBA as per Article 18(6) of the Law, using solely those cover assets which are counted for the purposes of such assessment;
- To the extent that the above assessment has been successfully met, any assets which are not required to meet such assessment, including relevant requirements under a contractual OC, are being released and become available to satisfy the claims of all other creditors, members and investors of the credit institution;
- To the extent that the above assessment has not been successfully met, the CBBA (*according to the provisions of Article 29(2) of the Directive*) is entitled to use any assets included in the cover pool register that do not meet the criteria, terms and conditions for counting a cover asset in the cover pool adequacy. (*To the extent that such assessment is not met, the CBBA has the right to accelerate or transfer the CB business to another approved institution, in accordance with Article 62 (1) of the Law*).

With respect to an automatic acceleration of the covered bonds, this is something that is not provided for by the Law, where a covered bond Issuer is subject to dissolution proceedings.

In accordance with Article 40(1) of the Law, all outstanding covered bonds will remain in force (subject to the terms and conditions under which they were issued), and the obligations of the covered bond Issuer under the covered bonds continue to be enforceable.

IX. RISK WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

The legislation when taken together with the practices, processes and procedures across the industry should fall within the criteria of Article 129 CRR. Cypriot covered bonds meet the criteria of UCITS 52(4).[5] This results in a 10% risk weighting assigned by the CBC. Covered bonds issued under the Cypriot Legal Framework form acceptable collateral for refinancing purposes with the ECB, following the typical ECB eligibility assessment and their inclusion on the ECB Eligible Assets Database (EADB).

X. ADDITIONAL INFORMATION

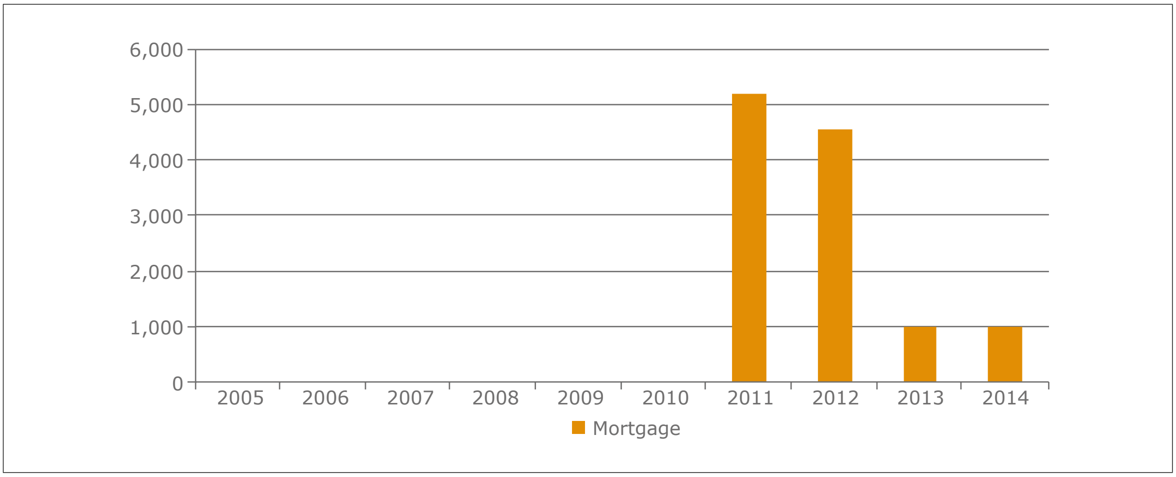
Covered bond issuers are, in accordance with Article 20 of the Law, required to maintain, throughout the life of the covered bonds, a set-off reserve in connection with cover assets that are subject to set-off.

The Directive provides for the maintenance of such a set-off reserve, in the form of additional assets which are included in the cover pool (Articles 22, 24 and 25 of the Directive).

The set-off reserve is quantified by the Issuer and such calculation is subject to the monitoring of the CBM. The set-off reserve is segregated from the Issuer's other assets, forming part of the cover pool where Cover Pool Creditors have a priority claim over amounts in such reserve.

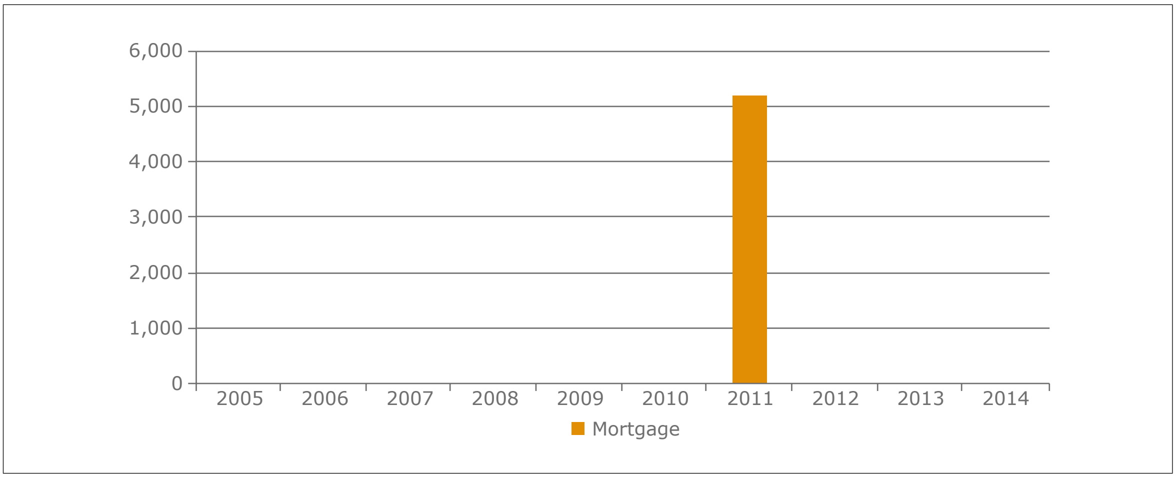
[5] Please click on the following link for further information on the UCITS Directive and the Capital Requirements Regulation (CRR): http://ecbc.hypo.org/Content/default.asp?PageID=504#position.

> Figure 1: Covered Bonds Outstanding, 2005-2014, EUR m



Source: EMF-ECBC

> Figure 2: Covered Bonds Issuance, 2005-2014, EUR m



Source: EMF-ECBC

Issuers: Bank of Cyprus Public Co Ltd.

ECBC Covered Bond Comparative Database: http://www.ecbc.eu/framework/93/Cyprus_CBs.

3.8 CZECH REPUBLIC

By Libor Ondřich, UniCredit Bank Czech Republic and Slovakia

I. FRAMEWORK

It has been possible to issue the mortgage Covered Bonds ("Hypotecni zastavni list" – hereinafter referred to as "MCB") in the Czech Republic from January 1, 1992 on the basis of the general regulation contained in the Commercial Code.

At present, the MCBs, the mortgage loans (hereinafter also referred to as "ML") and the other terms and conditions of mortgage financing are regulated in detail in the Bond Act (hereinafter also referred to as "BA"), which entered into force on April 1, 2004. The latest amendment has been effective since August 1, 2012, which, besides other things, enables issuance of the MCBs under a law different from the Czech law and clarifies the calculation of the minimum LTV required by the law.

Specific provisions treating cover assets and applicable at the opening of the insolvency proceedings or declaration of bankruptcy of the issuing bank are part of the Insolvency Act No. 182/2006 Coll.

II. STRUCTURE OF THE ISSUER

MCBs may only be issued by a bank holding a Czech banking license (i.e., a banking license issued under the Banking Act no. 21/1992) and having its registered office in the Czech Republic (an "Issuing Bank"). An Issuing Bank can generally pursue all business activities that are permitted for credit institutions and need not be a specialized bank. The MCBs constitute direct and unconditional obligations of the Issuing Bank, and the Issuing Bank is fully liable for any payment obligations thereunder. All obligations arising from the MCBs are obligations of the Issuing Bank as a whole to be paid from all the assets of the Issuing Bank, subject to specific provisions applicable to the Issuing Bank's insolvency (dual recourse).

III. COVER ASSETS

Pursuant to the BA, the MCBs are such covered notes where the nominal value of and revenue from which are fully covered with (i) receivables from MLs or parts of these receivables (the so-called "regular coverage") and (ii) by substitute collateral. The text "Mortgage Covered Bond" has to be a part of the name of this covered bond. No other securities and/or covered bonds are allowed to use this name.

ML is such loan that is secured with a mortgage to a real estate (residential mortgages, commercial mortgages, land, buildings under construction). The amount of receivables from ML must not exceed double the collateral value of the mortgaged real estate. The real estate under the mortgage right has to be located on the territory of the Czech Republic, a member state of the European Union or another country making a part of the European Economic Area. The loan is considered to be the mortgage loan on the day of origin of legal effects of the mortgage right registration.

The mortgage right securing the ML used to cover the MCBs has to be in the first position in the Real Estate Register. There are two exceptions to this rule: the real estate under mortgage may have a priority mortgage right securing a loan which:

> Is extended by a building society or a loan extended for a cooperative housing construction supported by the State. The precondition for this is that the building society or the creditor of the cooperative housing construction loan that have the priority sequence of the mortgage right have given a written consent to the issuer of MCBs to establish the mortgage right in a lower ranking. The receivable from the ML secured with a mortgage right not in the first position may not be used to cover the MCBs without such consent.

> Will be repaid so that the mortgage right related to the ML will move from the second position to the first position of registration in the Real Estate Register.

Substitutive Coverage

Substitute collateral is restricted to 10% of the nominal amount of MCBs outstanding. The following substitute assets are eligible:

- Cash;
- Deposits of the issuer at the Czech National Bank (hereinafter referred to as "CNB");
- Deposits at the Central Bank (National Bank) of a member state of the European Union or another country making a part of the European Economic Area or at the European Central Bank;
- Government bonds and/or securities issued by the CNB;
- Government bonds and/or securities issued by the member states of the European Union or by other countries making a part of the European Economic Area, their Central (National) Banks and the European Central Bank; and
- Government bonds issued by the financial institutions established with an international agreement the contracting party of which is the Czech Republic, or the financial institutions with which the Czech Republic entered into an international agreement.

IV. VALUATION AND LTV CRITERIA

Only the issuer's receivables arising from mortgage loans or parts thereof may be used for the proper coverage of the total obligations arising from all the mortgage bonds in circulation issued by one issuer. Such receivables or parts thereof may not, during the period when they are used for such coverage, exceed 70% of the aggregate mortgage lending value of the mortgaged property securing such receivables (70% portfolio LTV limit).

If any mortgage rights in priority sequence are attached at the same time to any real estate that serves to secure the construction savings credit or the cooperative housing construction loan, only the receivable from the mortgage loan or its part in the maximum amount of the difference between 70% of the mortgage lending value of the real estate under mortgage and the sum of the receivables from the loan extended by the building society and the cooperative housing construction credit may be used for the purposes of coverage of the MCBs.

The issuer of the MCBs determines the *mortgage lending value* of the real estate under mortgage, and namely as the *prudent market value*, taking into consideration:

- The permanent and long-term sustainable characteristics of the real estate under mortgage;
- The revenues attainable by a third party at regular management of the real estate;
- The rights and defects associated with the real estate; and
- The local real estate market conditions and impacts and presumed development of this market.

The *prudent market value* is considered to be such price that could be achieved in the event of the sale of the same or similar real estate as at the valuation date and in dependence on its condition and quality. The prudent market value should not reflect the extraordinary market circumstances, the personal relations between the participants and the subjective assessment of the interest of one of the parties. The *mortgage lending value* shall not exceed the *prudent market value* of the real estates.

The conditions allowing the use of the receivable from the ML to cover the MCBs have to be complied with throughout the period for which the receivable from the ML is included in the MCB coverage.

V. ASSET – LIABILITY MANAGEMENT

The sum of all the liabilities from all the MCBs in circulation issued by one issuer has to be fully covered with the receivables or their parts from the ML (regular coverage) or possibly in a substitutive manner (substitutive coverage). No other test is required by the law. Derivatives are not eligible cover assets.

VI. TRANSPARENCY

An initiative sponsored and coordinated by the Czech Banking Association aiming for the improvement of the covered bond legislation was launched in December 2012. The initiative prepares proposals for legislative changes, which should help to further promote soundness of the Czech covered bond market. The Bond Act and Insolvency Act are within the scope of this initiative. The changes are expected to become effective in 2015.

VII. COVER POOL MONITORING AND BANKING SUPERVISION

The issuer of the MCBs is obligated to keep separate and conclusive records on the summary of all of its liabilities from the MCBs in circulation issued by it and on its coverage. The content of the records is defined in an obligatory regulation by the CNB (Czech National Bank). Pursuant to this regulation, the issuer of the MCBs shall keep the Coverage Register and the Coverage Ledger.

The Coverage Register contains a summary of how the liabilities of the issuer of MCBs are covered – with both the regular coverage (i.e. the list of the receivables from the MLs used to cover the MCBs) and with the substitute collateral, if applicable. The records in the Coverage Register shall be updated by the issuer continuously as the changes occur.

The Coverage Ledger contains the full summary of the liabilities of the issuer from its MCBs in circulation and the valuation of the assets of the Coverage Register.

The records shall be kept in CZK in paper form or in electronic form. The recordkeeping including the insertion of the MLs for coverage and elimination of the MLs from the coverage shall be made by the departments independent of the departments responsible both for the extension of MLs and for issuance of the MCBs and namely up to the managing Board member.

VIII. SEGREGATION OF COVER ASSETS AND BANKRUPTCY REMOTENESS OF COVERED BONDS

In the event of bankruptcy or bankruptcy proceedings of the issuer of the MCBs, the receivables from the MCBs in circulation issued by it have a priority rank for satisfaction. The assets (the receivables from the ML) serving to cover the MCBs of the bankrupt issuer constitute the mortgage estate (cover pool). A special administrator may be appointed to administer the mortgage estate and to satisfy the claims resulting from the MCBs in circulation. The yield from the encashment of the mortgage estate shall be first used to satisfy the costs of administration and encashment of the mortgage estate and then immediately to satisfy the receivables of the MCBs without limitation of their amount. Only the rest shall be used to satisfy the other receivables from the bankrupt issuer. Otherwise there is no specific provision regarding the treatment of cash flows generally, including those received prior to opening of the insolvency proceedings or declaration of bankruptcy and those received afterwards. The current automatic acceleration of covered bonds is intended to be removed in the planned update of the legal framework for Czech covered bonds.

IX. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

The legislation when taken together with the practices, processes and procedures across the industry should fall within the criteria of Article 129 of the Capital Requirements Regulation (CRR)[1].

[1] Please click on the following link for further information on the UCITS Directive and the Capital Requirements Regulation (CRR): http://ecbc.hypo.org/Content/default.asp?PageID=504#position.

The risk-weighting of MCBs is regulated by the Czech National Bank decree no. 123/2007 Coll. transposing EU's Capital Requirements Directive into the Czech law. Risk-weight of 10% (under the standardized approach) is assigned provided that the MCB complies with the requirements of the Annex 4 of the aforementioned decree.

Czech investment legislation allows investment funds to invest up to 25% of the fund's assets in MCBs complying with the requirements of Article 52(4) UCITS Directive (Art. 28(2)(c) of the Czech Collective Investment Act).

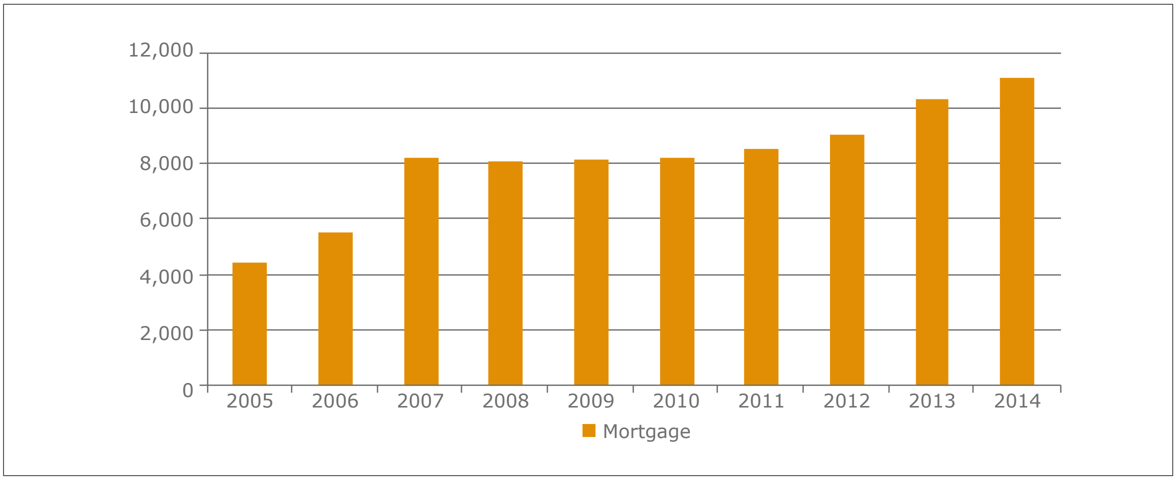
X. ADDITIONAL INFORMATION

State Incentives

The debtor from the ML may reduce his income tax base with the interests he has paid to the issuer from the ML used to finance his housing needs.

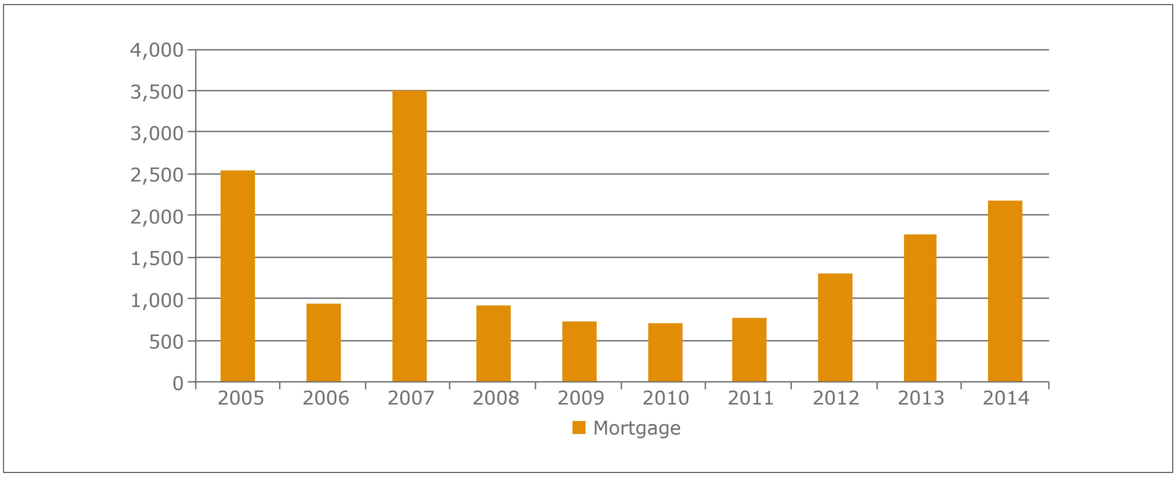
The interest revenues from MCBs are exempt from the income tax, provided that such MCBs were issued before the 1st of January, 2008 and are covered by receivables from MLs for housing investments.

> Figure 1: Covered Bonds Outstanding, 2005-2014, EUR m



Source: EMF-ECBC

> Figure 2: Covered Bonds Issuance, 2005-2014, EUR m



Source: EMF-ECBC

Issuers: There are eight issuers in the Czech Republic – Česká spořitelna, Československá obchodní banka, Hypoteční banka, Komerční banka, Raiffeisenbank, Sberbank CZ, Wüstenrot hypoteční banka, UniCredit Bank Czech Republic and Slovakia.

ECBC Covered Bond Comparative Database: http://www.ecbc.eu/framework/112/Czech_Republic_Covered_Bonds.

3.9 DENMARK

By Mette Saaby Pedersen, Association of Danish Mortgage Banks and Svend Bondorf, Nykredit

I. FRAMEWORK

In Denmark the legal basis for covered bond issuance is the Danish Mortgage-Credit Loans and Mortgage-Credit Bonds etc. Act (the "Mortgage Act") (*Lov om realkreditlån og realkreditobligationer mv.*) and the Danish Financial Business Act (*Lov om finansiel virksomhed*). The Mortgage Act is applicable only to Danish mortgage banks. The mortgage banks are specialised banks. The Capital Requirements Regulation (CRR) is directly applicable to the commercial banks and the mortgage banks.

Specific bankruptcy regulations laid down in the Financial Business Act and the Mortgage Act prevail over general bankruptcy regulations (sections 247a-247i of the Financial Business Act and sections 22-33 of the Mortgage Act).

II. STRUCTURE OF THE ISSUER

The Danish Financial Supervisory Authority (FSA) may license mortgage banks, commercial banks and ship financing institutions[1] to issue covered bonds.

Until 1 July 2007, only mortgage banks were allowed to issue mortgage covered bonds. Since this date, also commercial banks can obtain a license to issue covered bonds.

This leads to the existence of three types of Danish covered bonds:

> Særligt Dækkede Obligationer (SDOs) issued by either commercial or mortgage banks. SDOs are both UCITS (Article 52(4)) and CRR compliant (Article 129).

> Særligt Dækkede Realkreditobligationer (SDROs) issued exclusively by mortgage banks, fulfilling the former as well as the new legal requirements. SDROs are both UCITS (Article 52(4)) and CRR compliant (Article 129).

> Realkreditobligationer (ROs) issued exclusively by mortgage banks. ROs are UCITS compliant (Article 52(4)).

In addition, all ROs issued before 1 January 2008 have maintained their covered bond status in accordance with the grandfathering option under the CRR. The grandfathered bonds are both UCITS (Article 52(4)) and CRR (Article 129) compliant.

The covered bond legislation in Denmark allows for joint funding, i.e. two or more institutions joining forces to issue covered bonds in order to achieve larger issues. The first issue of joint funding between non-affiliated institutions took place in 2012.

Danish mortgage banks operate subject to a specialist banking principle in accordance with Danish legislation, which confines the activities of issuers to the granting of mortgage loans funded by the issuance of covered bonds. The cover pool may include unsecured loans to public authorities and guarantees issued by public authorities but this is not rarely used. Mortgage banks may also carry on other business related to mortgage banking.

The specialist banking principle implies that mortgage banks are confined to granting loans that meet the requirements for cover assets imposed by legislation. Similarly, the funding sources are limited to ROs, SDOs and SDROs. This is due to the fact that Danish mortgage banks are not allowed to accept deposits, etc. as a source of funding, cf section 8 of the Financial Business Act.

The issuer (mortgage bank or commercial bank) holds the cover assets on its balance sheet as well as all rights under the cover assets. Bonds and cover assets are assigned to individual capital centres in mortgage banks and to registers in commercial banks. The individual bonds, however, are not linked to individual mortgage loans.

[1] Ship financing institutions are regulated by the Act on a Ship Financial Institute (Consolidating Act no 886-8 August 2011).

Issuers have their own employees. Outsourcing of activities is allowed if control measures are deemed satisfactory by the FSA, and consumer protection regulations are observed.

III. COVER ASSETS

Assets eligible as the basis for mortgage covered bond issuance:

SDO	SDRO	RO
> Loans secured by real property > Exposures to public authorities > Exposures to credit institutions (up to a maximum of 15 %) > Collateral in ships (not an option for mortgage banks)	> Loans secured by real property > Exposures to public authorities	> Loans secured by real property > Exposures to public authorities

To serve as cover assets, mortgages must be entered in the Danish land register, which is kept by the Danish district courts. Land and loan registration has been digital since 2009 with faster and more efficient handling of customers' loans as a result.

The mortgage loans are originated in a mortgage bank or a credit institution in the same group, or transferred to a mortgage bank according to a structure in which the mortgage bank has knowledge of and is responsible for correct valuation of the mortgaged property and verification of the debtor's creditworthiness and ability to pay.

The difference between funding and lending may be hedged through derivatives, which are included in the cover pool assets.

In a capital centre in a mortgage bank the cover pool is dynamic as a result of the current addition and disposal of loans in connection with the granting and repayment of loans. In most capital centres assets may exclusively be transferred to or from the cover pool upon new lending and (p)repayment. On (p)repayment, the corresponding amount of issued bonds will be transferred from the capital centre. Each mortgage loan (cover asset) refers to specific ISIN codes and both cover assets and ISIN codes are assigned to specific capital centres. It is therefore not possible for the issuer to (i) change the cover pool unless in connection with new lending and (p)repayment nor (ii) transfer cover assets between different cover pools. Such cover pools are thus less dynamic than cover pools where existing mortgages can be transferred into and out of the cover pools. Cover assets must be identifiable, and the FSA supervises cover asset identification.

IV. VALUATION AND LTV CRITERIA

The financial legislation contain provisions on property valuation. Valuations are based on the open market value of a property.

LTV limits – an overview

Loan Type Property category	SDO	SDRO	RO
Residential property	80% or 75%[1)]	80% or 75%[1)]	80%
Holiday property	60%	60%	60%
Agricultural property	60%[2)]	60%[2)]	70%
Commercial property	60%[2)]	60%[2)]	60%

Note: 1) 80% for loans issued with up to 30 years maturity and 10 years interest-only period and 75% for loans with an unlimited maturity and interest-only period.

2) The LTV can be raised to 70% if the bank adds additional collateral.

In connection with the issuance of SDOs and SDROs, mortgage banks and commercial banks must ensure continuous LTV compliance – ie not just at disbursement of the loan as is the case for ROs. Where an LTV ratio exceeds the statutory limits, the bank must add supplementary collateral to the capital centre/register. Otherwise, the issues may lose their status as SDOs or SDROs.

Mortgaged property is valued (on-site inspection) as part of the processing of loan applications. When a loan is granted, the LTV thereof is assessed on a case-by-case basis. A basic principle of the valuation regulations is that valuations must be performed by a valuation officer of an issuer. Provided that a number of conditions are met, valuations may be outsourced. The detailed conditions are set out in the financial legislation.

V. ASSET – LIABILITY MANAGEMENT

The financial legislation and the Executive Order on bond issuance, balance principle and risk management require mortgage banks and commercial banks to observe a balance principle and a set of rules on risk management in connection with the issuance of RO, SDRO and SDO.

The Executive Order provides limits to the scope of differences allowed between on one hand the payments from borrowers and on the other hand the payments to the holders of the issued ROs, SDROs and SDOs. The limits are adjusted by loss limits to the interest rate, foreign exchange, option and liquidity risks that follow from cash flow differences in the balance sheet. The Executive Order also contains a number of other provisions limiting financial risk.

For commercial banks, the balance principle is applicable at register level. For mortgage banks, the balance principle is applicable at the level of the individual capital centres and the banks in general.

For each register/capital centre, mortgage banks and commercial banks must choose whether to comply with either the *specific balance principle* or the *general balance principle*. The choice of balance principle does not depend on the choice of bond type (RO, SDRO or SDO) issued out of the register/capital centre. The differences between the two balance principles are as follows:

Types of risk	Specific balance principle	General balance principle
Interest rate risk	Stress test on level and structure + Loss limit of 1% of capital base + Risks in different currencies cannot be set off	Stress test on level and structure Loss limit for **mortgage banks** dependent of stress test: 1%/ 5% of capital adequacy requirement + 2%/10% of the additional excess cover Loss limit for **commercial banks** dependent of stress test: 10%/100% of excess cover
Currency risk	Exchange rate indicator 2 (few currencies) + Loss limit of 0.1% of capital base	Simple stress test Loss limit for **mortgage banks**: 10% of capital adequacy requirement + 10% of the additional excess cover for EUR and 1% of capital adequacy requirement + 1% of additional excess cover of other currencies Loss limit for **commercial banks**: 10% of excess cover

Types of risk	Specific balance principle	General balance principle
Option risk	Maximum term of 4 year + Structural limits on call options and index-linking	Stress test on volatility Loss limit for **mortgage banks**: 0,5% of capital adequacy requirement + 1% of the additional excess cover No maturity or structural limits Loss limit for **commercial banks**: 5% of excess cover No maturity or structural limits
Liquidity risk	Limitations on temporary liquidity deficits 25% (years 1-3) 50% (years 4-10) 100% (from year 11)	Limitations on interest payments: Interest (in) > Interest (out) (over a current period of 12 months) + Present value PV (in) > PV (out) (always)
Repayment of loans by bonds other than the underlying bonds	Max. 15%. Both own issued bonds and bonds from other credit institutions + Approximately same cash flow	Max. 15% from other credit institutions – Own issued bonds unlimited

Despite the risk limits of the balance principle, Danish mortgage banks have in practice structured their mortgage lending business in such a way that they do not assume significant financial risks with respect to mortgage lending and funding. Thus, the mortgage banks have nearly eliminated interest rate risk, foreign exchange risk and prepayment risk.

Since mortgage bond issuance is the only eligible funding source for Danish mortgage banks, issuance takes place on a daily basis. The mortgage bank commonly achieves this through *tap issuance*. Each loan is closely matched to the future cash flow of one or several specific ISIN codes currently open for issuance. On any given banking day the mortgage bank calculates the bond amounts to be tapped in the relevant ISINs corresponding to the loans disbursed that day. These bond amounts are then issued and sold to investors. These simple principles ensure that the balance principle is maintained day by day and minimizes the subsequent need for active asset-liability management.

A typical mortgage ISIN is open for tap issuance for several years after opening. Issuance trades are executed alongside with other trades in a unified, highly liquid and tightly priced market. Thus, there is no strict distinction between primary and secondary markets in the Danish system.

The Danish commercial banks, too, are subject to the strict ALM rules. In practice the commercial banks operate under a general asset and liability management and do not offer pass-through products.

To address refinancing risk the legislation was amended in 2014. The new regulation applies to bullet bonds and floating-rate bonds where the loan term is longer than the maturity of the bond used to fund it. The rules were implemented on 1 April 2014 for bonds with an original maturity up to 12 months and came into effect for longer bonds, too, on 1 January 2015. The new regulation introduces a soft bullet mechanism controlled by two triggers: a refinancing failure trigger and an interest rate trigger, either of which may extend the bond maturity by 1 year. The interest rate trigger, which applies solely to bond maturities of 2 years or less, comes into effect in case of a 5 % point bond yield increase over the last year before ordinary maturity. The new legislation has provided clarity for the position of borrowers, investors and mortgage banks in an extreme crisis where a mortgage bank is unable to complete the refinancing by sale of bonds at market terms, or interest rates suddenly rise very sharply.

According to the legislation, the capital base must represent at least 8% of risk-weighted assets. Mortgage banks must observe the capital adequacy requirement both at individual capital centre level and at the level of the institution. Overcollateralisation forms part of the cover pool.

VI. TRANSPARENCY

A high level of transparency is an important characteristic of the Danish covered bond market. The Danish covered bond issuers publish information via many different platforms, such as prospectuses, investor reports, trading venues and issuers' investor relations web sites.

Information is thus easily accessible. Previously the information has been somewhat fragmented, requiring investors to seek and collect information from different sources and in different formats.

To complement the ECBC Label Initiative, the Danish market participants have gathered available information and consolidated it in an intuitive and user-friendly structure in the national transparency template. The Danish issuers report data uniformly cell by cell in excel format as specified in the transparency template. The uniform reporting makes it easy for investors to compare data across issuers' cover pools and to extract data for further analysis.

The establisment of the national transparency template provides investors a single point of entry for the extensive information available on covered bond issues – be it SDO, SDRO or RO with means to compare key information across an array of issuers. The template is a valuable tool that supports covered bond investors' investment decisions by comprehensive overview of covered bond issues and making comparison of key information easier.

VII. COVER POOL MONITOR AND BANKING SUPERVISION

General banking supervision is carried out by the Danish FSA (Denmark has not joined the single supervisory mechanism – SSM). The FSA supervises compliance with the legislative framework for carrying on mortgage banking activities and thereby the issuance of covered bonds.

The issuer monitors the cover pool continuously. Data from every single loan offer from the Danish mortgage banks and thus all property valuations for new lending purposes are reported to the FSA on a quarterly basis. The FSA performs random checks of mortgage banks' valuations by way of on-site inspections and by checks of the internal valuation reports and which other property has been used as reference to the basis for the valuation. In the Danish mortgage model where loans are originated, serviced and redeemed directly in the cover pool, there is no need for monitoring other than as provided by the FSA.

The commercial banks report on a quarterly basis to the FSA on the assets in the register. The statement of the registered assets must be verified by the external auditor of the bank.

Issuers are also required to prepare comprehensive reports on asset-liability management for the FSA on a quarterly basis. The FSA must be informed of any balance principle breaches without delay. If the capital requirement is not observed, the FSA must be informed without delay.

The FSA has the authority to issue an order with which the issuer must comply. In case of severe or multiple breaches of Danish law or of such orders, the FSA may revoke the operating licence and dismiss the management of the issuer, cf sections 373-374 of the Financial Business Act.

In 2014 a new set of macro-prudential tools has been introduced for Danish mortgage banks – known as the Supervisory Diamond for mortgage banks. The Supervisory Diamond is soft law based on quarterly reports submitted by the mortgage banks to the Danish FSA. The values reported are compared with a number of predefined limit values for five selected indicators. The indicators are interest-only loans, loans with short-term funding, borrower's interest rate risk, lending growth and concentration risk. If the limit values are breached, the Danish FSA opens a dialogue with the bank concerned. Upon individual and concrete assessment, the Danish FSA may take action, for instance in the form of increased supervision, risk disclosure requirements or orders.

VIII. SEGREGATION OF COVER ASSETS AND BANKRUPTCY REMOTENESS OF COVERED BONDS

Capital centres of mortgage banks (regardless of whether the issuer has issued ROs, SDROs or SDOs)

The rules for resolving a mortgage bank are detailed and well considered.

The main considerations are to ensure (i) that bond investors receive timely payments and (ii) that the rights of borrowers are not prejudiced materially.

Balance sheets of Danish mortgage banks are structured with a number of separate capital centres (cover pools) out of which covered bonds are issued. A capital centre consists of a group of series in which covered bonds backed by an equivalent amount of mortgage loans (match funding) are issued and a joint series reserve fund (equity). In addition, supplementary capital (senior secured debt/junior covered bonds) may be issued out of the capital centre for overcollateralisation purposes.

If a mortgage bank is declared bankrupt, a trustee in bankruptcy is appointed. The Danish FSA may declare a mortgage bank bankrupt.

The trustee looks after the interests of the estate in bankruptcy, i.e. the interests of the creditors and particularly the covered bond investors in relation to the individual capital centres. Today, the creditors of a mortgage bank are almost exclusively covered bond investors. The trustee must seek the most efficient administration of the estate, having regard to the fact that the position of covered bond investors and borrowers must remain essentially as if the capital centre had still been a going concern. If a mortgage bank is declared bankrupt, no acceleration therefore takes place in respect of covered bond investors or borrowers. This is the key principle. It is only possible because the mortgage system is structured around capital centres that offer very high statutory collateral for bonds based on ring-fenced, bankruptcy-remote capital centres and match-funded lending.

Resolution is not fast, but orderly, with a minimum of changes for both bond investors and borrowers. No public funds are used for such resolution, as borrowers' ongoing payments are passed through to bondholders. Holders of hybrid core capital and subordinate loan capital cannot use the bankruptcy of a mortgage bank as grounds for a claim of default. Similar rules apply to counterparties to financial instruments used to hedge risk in a capital centre.

The practical duty of a trustee is to simulate a going concern. Borrowers' rights in respect of prepayment are unchanged. The trustee must, as far as possible, continue to make payments to bond investors and to look after the interests of existing borrowers. The trustee may not issue new loans or otherwise expand business, as the mortgage lender's licence to carry on mortgage banking has been withdrawn.

The trustee may issue bonds to refinance bonds which have matured (adjustable-rate mortgages). But such issuance may only take place if the trustee deems that there are "sufficient funds" to satisfy the claims of creditors. The bonds may also be extended by 12 months at a time, if there is an insufficient number of buyers for the bonds.

The trustee may also raise other loans for the purpose of paying bond investors. Such loans cannot be secured against existing mortgages, as these already serve as security for the issued covered bonds.

The trustee may transfer a total capital centre to another mortgage lender as an independent asset. A full transfer must be authorised by the Danish Minister for Economic and Business Affairs. Bondholders do not have a right of early redemption as a result of such transfer. Transfer in cases other than bankruptcy/suspension of payments requires the consent of creditors in accordance with the general rules of Danish legislation on the change of debtors as well as prior public authority approval.

If a mortgage lender is declared bankrupt, the assets, after deduction of estate administration costs, will be segregated to satisfy bond holders, etc., in accordance with their legal position as secured creditors. Covered bond holders have a primary secured claim against all assets in the cover pool. Counterparties to financial instruments used to hedge risk in a capital centre rank pari passu with covered bond holders in the relevant capital centre.

Proceeds from loans raised for the purpose of overcollateralisation (senior secured bonds/junior covered bonds) will serve to satisfy the claims of covered bond holders in case of bankruptcy. Any excess funds will be repaid to the lender.

The EU Bank Recovery and Resolution Directive (BRRD) has been implemented in Danish regulation and came into force on 1 June 2015. The bail-in tool does not apply to covered bonds (SDO, SDRO and RO) and senior secured debt/junior covered bonds. While exempt from bail-in, the Danish mortgage banks is subject to a 2% debt buffer of unweighted loans. The debt buffer must be fulfilled by 2020.

In case of resolution the debt buffer can be used by the resolution authority (in Denmark the resolution authority is Finansiel Stabilitet) to capitalise the mortgage banks when using BRRD resolution tools other than the bail-in tool. These tools can only be used according to the principle of "no-investor- worse-off". Otherwise the winding-up will be handled according to the above mentioned principle.

Commercial bank registers

A commercial bank sets up a register segregating assets, which exclusively serve as SDO cover assets.

As is the case with mortgage banks, derivative counterparties have a primary preferential right in line with the SDOs provided that the derivatives contract stipulates that the suspension of payments or bankruptcy of a commercial bank does not constitute an event of default. Bonds issued to secure assets as compensation for LTV excess or overcollateral in general (also referred to as junior covered bonds or senior secured bonds) have a secondary preferential right to all assets of the register.

The register is kept by the commercial bank and must at all times contain all assets, guarantees received and derivatives contracts, clearly individualised. The commercial bank must submit statements of the assets to the FSA. The external auditor must perform continuous regular control of the register and at least twice a year make unannounced of register audits.

Where the FSA suspends the licence of a commercial bank to carry on banking business, the FSA or the bank files a bankruptcy petition, or the bank is adjudicated bankrupt following the petition of a third party, the FSA will decide whether the register is to become subject to administration by an administrator as an estate in administration. The administrator (and not the ordinary trustee) will be in charge of the assets of the register.

Any unsatisfied residual claims by SDO holders and derivative counterparties against the register may be proved against the assets available for distribution of the commercial bank, but – contrary to the proceedings related to mortgage banks – exclusively as ordinary claims. Residual claims from junior covered bonds or senior secured bonds may also be proved as ordinary claims against the assets available for distribution.

The register is – contrary to the capital centres of mortgage banks – not subject to any specific statutory minimum requirement as to capital adequacy. The 8% capital adequacy requirement must only be fulfilled at the level of the commercial bank.

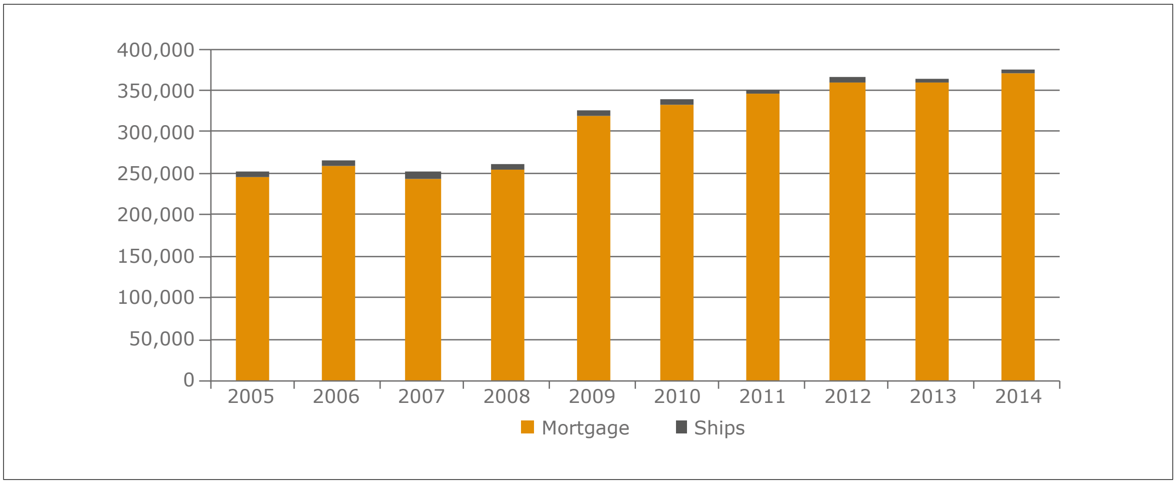
IX. RISK-WEIGHTING AND COMPLIANCE WITH EUROPEAN LEGISLATION

SDOs, SDROs and ROs fulfill the criteria of Article 52(4) UCITS. SDOs and SDROs also fulfill the requirements of Article 129 CRR.[2] ROs issued before 1 January 2008 maintain the low risk weighting of 10% throughout the maturity of the bonds in accordance with the grandfathering option under the CRR. ROs issued after 1 January 2008 carry a risk weight of 20%. ROs, SDOs and SDROs are eligible for repo transactions and may be used as collateral for loans with the Danish central bank (Danmarks Nationalbank).

When investing in ROs, SDOs and SDROs, the Danish investment legislation allows pension funds, etc., to exceed the usual limits on exposures to a single issuer. Thus, acknowledging the reduced risk associated with covered bond assets (cf the Financial Business Act (for insurers) and the Act on Investment Associations and Special-Purpose Associations as well as other Collective Investment Schemes etc.).

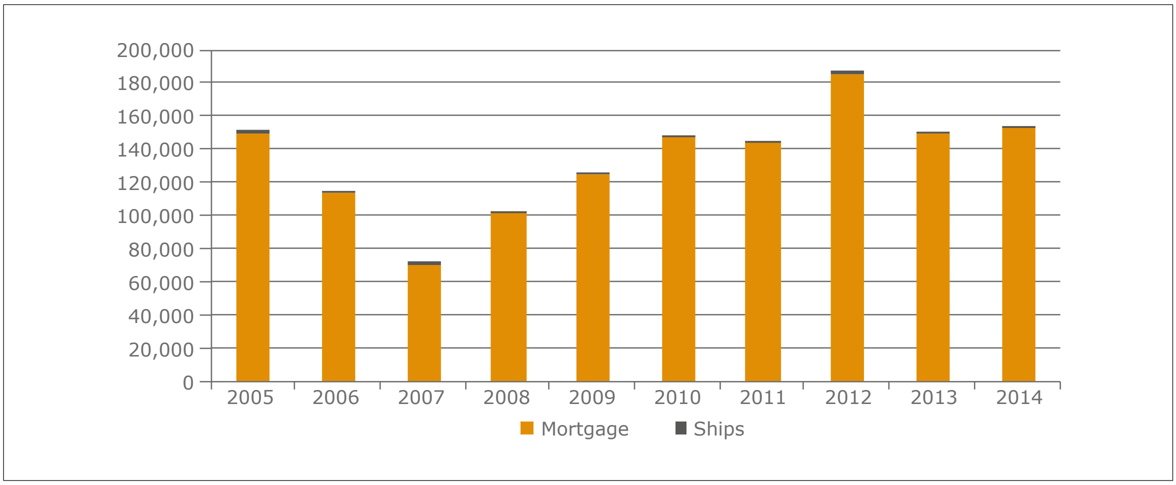
[2] Please click on the following link for further information on the UCITS Directive and the Capital Requirements Regulation (CRR): http://ecbc.hypo.org/Content/default.asp?PageID=504#position.

> Figure 1: Covered Bonds Outstanding, 2005-2014, EUR m



Source: EMF-ECBC

> Figure 2: Covered Bonds Issuance, 2005-2014, EUR m



Source: EMF-ECBC

Issuers: Covered bonds backed by real estate collateral are primarily issued by the specialised mortgage banks: BRFkredit a/s, DLR Kredit A/S, LR Realkredit A/S, Nordea Kredit Realkreditaktieselskab, Nykredit Realkredit A/S (incl. Totalkredit A/S), Realkredit Danmark A/S. At the end of 2014 the mortgage banks' outstanding volume of covered bonds was EUR 336 bn. Since the current Danish regulation on covered bonds entered into force on 1 July 2007, only one commercial bank, Danske Bank A/S, has utilised the possibility to issue covered bonds. Danske Bank has issued non-pass-through (euro-style) covered bonds of a value of around EUR 22 bn. Danish Ship Finance is the only Danish issuer of covered bonds backed by ship loans.

ECBC Covered Bond Comparative Database: http://ecbc.eu/framework/87/S%C3%A6rligt_D%C3%A6kkede_Obligationer_-_SDO, http://ecbc.eu/framework/88/S%C3%A6rligt_D%C3%A6kkede_Realkreditobligationer_-_SDRO and http://ecbc.eu/framework/89/Realkreditobligationer_-_RO.

Covered Bond Label: BRFkredit a/s Capital Center E; Danish Ship Finance General Capital Center; Danske Bank A/S Cover Pool D – Denmark; Danske Bank A/S Cover Pool I – International; Danske Bank A/S Cover Pool C – Commercial; DLR Kredit A/S Capital Center B; Nordea Kredit Capital Center 1/ Norde Kredit Capital Center 2; Nykredit Capital Center E; Nykredit Capital Center H; Realkredit Danmark A/S Capital Center S; Realkredit Danmark A/S Capital Center T.

3.10 FINLAND

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I. FRAMEWORK

There are currently five issuers of Finnish covered bonds. The five Finnish covered bond issuers have eight covered bond programmes. Three covered bond programmes are legacy programmes, i.e. are no longer used for public issuance.

In Finland, the legal basis for covered bond issuance is the Act on Mortgage Credit Bank Operations (HE 42/2010). The new legal framework replaced the old Act on Mortgage Credit Bank (1999) and entered into force on 1 August 2010. The new law overruled the special banking principle and gathered all Mortgage Credit Bank related legislation under the same act. Besides, other technical changes, e.g. mixed pools, have been allowed.

The provisions of the new legal framework do not apply to covered bonds issued or derivatives contracts registered before the entering into force of the new act. No counterparty restrictions apply and derivative counterparties are typically internal.

II. STRUCTURE OF THE ISSUER

The issuer of Finnish covered bonds can be a universal bank or a specialist mortgage bank. Generally, entities that can issue covered bonds are credit institutions authorised to engage in mortgage credit bank operations. The issuer of Finnish covered bonds can still be a specialised bank, but deposit banks or credit entities are entitled to apply for a licence to issue covered bonds. The existing specialised banks tend to stay in business in the way they have been operating since being established. Unless it is a mortgage credit bank, the issuer must obtain a license to engage in mortgage credit bank operations (i.e., issue covered bonds).

The Finnish covered bond law stipulates certain requirements to receive a covered bond issuance license. The covered bond issuer should provide a business plan, show financial stability, expertise in mortgage credit operations, risk management and practices concerning valuation of collateral. Interestingly, the requirements to receive a Finnish covered bond license seem very similar to the requirements to receive a German Pfandbrief license.

The issuer holds the cover assets on the balance sheet. A subsequent transfer of the cover assets to another legal entity is not taking place. A direct legal link between single cover asset and the covered bonds issued does not exist. All obligations from Finnish Covered Bonds are direct and unconditional obligations of the issuing bank as a whole. In the case of insolvency, the cover pool is segregated by law from the general insolvency estate and is reserved only for the claims of the holders of Finnish Covered Bonds.

Under the previous legal framework, only bonds covered by mortgages were issued by Finnish mortgage banks. A separate cover pool was to be established if these banks were to start the issuance of public-sector backed Finnish Covered Bonds. Under the new law, mixed pools comprising mortgage loans as well as eligible public sector assets are allowed.

III. COVER ASSETS

Finnish covered bonds have a cover pool register that includes all cover pool assets, covered bonds and derivatives. Eligible assets for Finnish covered bonds are residential mortgage loans (including shares in Finnish housing companies), commercial mortgage loans, public sector loans and substitution assets. At least 90% of the cover pool loans must consist of residential mortgage loans, public-sector loans or substitution assets. Cover pool assets can be within European Economic Area countries.

Enforcement of non-Finnish cover pool assets would usually be determined by the laws of the jurisdiction in which the assets. Due to European law, inside the EU, enforcement is safeguarded anyway. However, Finnish issuers have so far only Finnish assets in the covered bond pools.

Derivatives may also be registered in the cover pool. The geographical scope of cover assets is restricted to the European Economic Area (EEA). Residential mortgage loans, shares in housing companies as well as commercial mortgage loans up to 10% of the total pool are eligible as cover assets.

Public sector loans in accordance with Article 129(1) CRR are also eligible.

A new feature in the law is that a specialised mortgage credit bank can grant an intermediate credit to a deposit bank or a credit entity. This intermediate credit must be covered with eligible cover assets as stated above. These assets must also be recorded into the cover register.

Up to 20% of the mortgage cover pool is allowed to consist of substitute cover assets; bonds and other debt obligations issued by the State, a municipality or another public-sector organisation or another credit institution than one belonging to the same consolidation group as the issuer; a guarantee as for own debt granted by a public-sector organisation or credit institution referred above; a credit insurance given by an insurance company other than one belonging to the same group, referred to in the Act on Supervision of Finance and Insurance Groups; cash assets of the issuer deposited in the Bank of Finland or a deposit bank with the restriction that if the issuer is a deposit bank the cash deposit may not be in a deposit bank belonging to the same consolidation group as the issuer.

ABS or MBS tranches are not eligible for the cover pool.

Derivatives are eligible for the cover pools only if they are used for hedging purposes.

The nature of the cover pool is dynamic. Currency risk is perfectly matched as the law requires cover assets to be in the same currency as the covered bonds.

IV. VALUATION AND LTV CRITERIA

The property valuation within the legal framework for covered bonds in Finland is based on market values, valuations are based on “current value”, market value determined in accordance with FFSA regulations. Based on the updated regulation, the issuer needs to monitor the valuation of the property also based on statistical methods (indexed value) quarterly and set limits for the acceptable changes of the values. Should the value exceed or drop below the limits the property valuation needs to be updated accordingly.

There are different LTV levels for residential and commercial mortgage loans: 70% of the value of the residential property and 60% of the value of the commercial property accepted. This LTV is a relative limit, i.e. when a loan exceeds the 60%/70% limit, the part of the loan up to 60%/70% LTV remains eligible to the cover pool. A loan placed as collateral for a covered bond may not exceed the current value of the property standing as collateral.

V. ASSET – LIABILITY MANAGEMENT

There are legal standards for Asset-Liability Matching in the Finnish Covered Bond System. For instance, the aggregate interest received on the cover assets in any 12-month period must exceed the interest paid on the outstanding covered bonds. This regulation takes derivatives for hedging purposes into account.

The total amount of collateral of covered bonds shall continuously exceed the remaining combined capital of the covered bonds.

The net present value of the total amount of collateral of covered bonds shall continuously exceed by at least 2% the total net present value of the payment liabilities resulting from the covered bonds. The net present value test helps mitigate interest-rate, currency and liquidity risk.

As mentioned above, interest receivable on cover assets must be sufficient to cover interest payable on covered bonds on a twelve month rolling basis. Moreover, the test needs to be stressed by +/- 1%. In case of a breach of one of these rules mentioned, the issuer might face sanctions from the FSA. Ultimately, the issuer might face the loss if its licence. In addition to the 2% net present value legal minimum, further OC may be committed by contract. Non-performing loans (defined as 90 days past due) are excluded from cover tests. Assets that are ineligible for Finnish covered bonds (.e.g. non-performing loans) are excluded from the cover tests, but can be retained in the cover pool and lead to additional OC.

VI. TRANSPARENCY

The annual and interim reports of the issuer indicates, in addition to that provided in the act on Credit Institutions, the basis of the valuation of the collateral and the amount of residential mortgage loans and possible intermediary loans and public sector loans issuer has granted, as well as the amount of covered bonds issued.

The leading Finnish issuers have adopted the ECBC Label initiative for Covered Bonds and created Finnish National Transparency Template: https://www.coveredbondlabel.com/issuers/national-information-detail/9/.

On top of the regulatory requirements all issuers provide additional information about the cover pools, ratings and other relevant topics on their websites. Please find the website information at section X, Additional information.

VII. COVER POOL MONITOR AND BANKING SUPERVISION

The issuer carries out the monitoring of the cover pool. The issuer reports to the FSA on a monthly basis. With regard to UCITS 52(4), this supervision of a specialised bank as issuer of the covered bond is compliant to the "special supervision". The FSA is responsible for overall supervision, covered bond licensing, issuing regulations and compliance with the law.

The FSA has the legal power to take appropriate measures. It is allowed to conduct inspections at the bank in question or to require documents. Also, the FSA could issue a public warning or admonition. Ultimately, it is up to the FSA to revoke the banking licence of the bank in question.

With regard to UCITS 52(4), this supervision of a specialised bank as issuer of the covered bond is compliant to the "special supervision".

VIII. SEGREGATION OF COVER ASSETS AND BANKRUPTCY REMOTENESS OF COVERED BONDS

A cover register allows identifying the cover assets. The legal effect of a registration of assets into the cover register is to create the priority claim of covered bond holders to these cover assets in case of an insolvency of the issuer. The cover register is managed by the corresponding bank, which in turn is supervised by the FSA.

The cover register contains information about the principle amount of covered bonds issued, the mortgages and substitute assets covering these bonds as well as derivative transactions hedging these bonds or funds placed as their collateral. The Finnish covered bond law specifically excludes set-off against cover pool assets. The law also specifically excludes claw-back risk.

Asset segregation

The cover pool is a part of the general estate of the bank as long as the issuer is solvent. If the insolvency proceedings are opened, by operation of law, the assets recorded in the cover registers are excluded from the general insolvency's estate. When the insolvency proceedings are opened, the FSA appoints a special cover pool administrator. Within the insolvency procedure, the derivative counterparties rank pari passu to covered bond holders. The cover assets do form a separate legal estate, which is ring-fenced by law from other assets of the issuer.

Impact of insolvency proceedings on covered bonds and derivatives

Covered bonds do not automatically accelerate when the issuing institution becomes insolvent. The legal consequences for the derivatives in case of an insolvency of the issuing bank depend on the relevant contracts. The cover pool administrator can only accelerate the covered bonds if the cover tests can no longer be fulfilled. This would trigger the sale of the cover pool assets.

Following issuer default, the regulator is not a manager or servicer of last resort. However, a cover pool supervisor is appointed to supervise the interests of covered bondholders, with powers to direct the issuer's general administrator.

The cover pool supervisor will supervise cover pool cash flows and payments to covered bondholders. The general administrator also has powers to act in the interests of the covered bondholders under the direction of the cover pool supervisor. This includes the ability to assign the liability for a covered bond as well as the related cover pool assets to another licensed covered bond issuer (with the permission of the FSA).

Preferential treatment of covered bond holders

Covered bond holders enjoy a preferential treatment as the law stipulates the separation of the cover assets on the one hand and the insolvency's estate on the other.

The satisfaction of the covered bond holders is not limited to the cover assets in the Finnish system. On the contrary, those creditors also participate in the insolvency proceedings in respect of the remaining assets of the bank.

A moratorium on the insolvency's estate cannot delay the cash flows from the cover assets and, therefore, endanger the timely payment of covered bond holders.

Access to liquidity in case of insolvency

With the appointment of the cover pool administrator, this person acts on behalf of the covered bond holders. The pool administrator has access to the cover assets. Cover assets may only be disposed with the consent of the FSA. Additionally, the pool administrator has also the first access on cash flows generated by the cover assets. The law foresees a possibility for the pool administrator together with the bankruptcy trustee to take up a loan on behalf of the cover pool to create more liquidity.

Up to 20% of the cover pool may consist of liquid substitute cover assets. Substitute assets are deposits, bonds or guarantees of public sector entities or credit institutions and certain credit insurance. With the consent of the FSA, this limit may even be higher. As all cover assets entered into the cover register are ring-fenced in case of an insolvency of the issuer, this results also in the insolvency remoteness of voluntary over-collateralisation.

Some Finnish covered bonds mitigate liquidity risk via contractual 12 month maturity extensions ("Soft Bullet"). The extension provides additional time for principal amounts to be refinanced. Combined with the interest coverage test, maturity extensions improve the chance that principal and interest payments can be met without refinancing the covered bonds for the first twelve months after issuer default.

IX. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

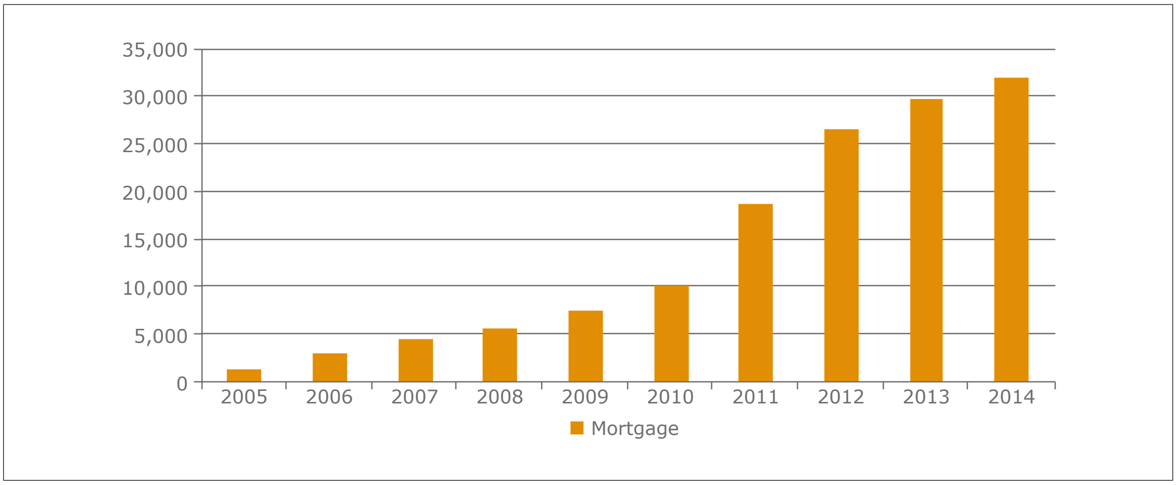
Finnish Covered Bonds comply with the requirements of Art. 52(4) UCITS Directive. The legislation when taken together with the practices, processes and procedures across the industry should fall within the criteria of Article 129 of the Capital Requirements Regulation (CRR)[1]. Therefore, these bonds are 10% risk weighted in Finland. Following the common practice in Europe, they accordingly enjoy a 10% risk weighting in most European countries.

Finnish Covered Bonds are also eligible in repo transaction with national central bank, i.e. within the Eurozone.

[1] Please click on the following link for further information on the UCITS Directive and the Capital Requirements Regulation (CRR): http://ecbc.hypo.org/Content/default.asp?PageID=504#position

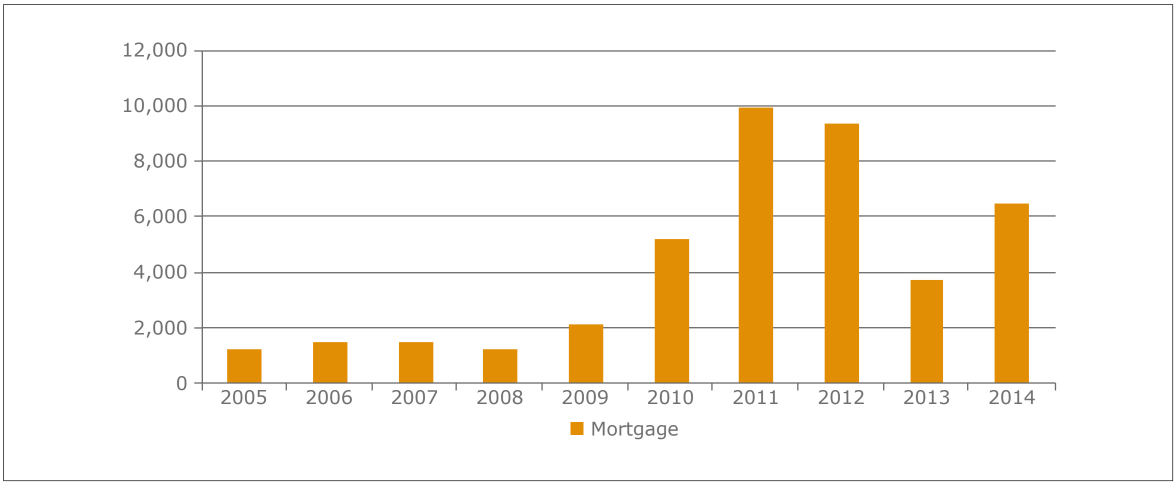
As far as the domestic issuers are aware, there are no further specific investment regulations regarding Finnish Covered Bonds.

> Figure 1: Covered Bonds Outstanding, 2005-2014, EUR m



Source: EMF-ECBC

> Figure 2: Covered Bonds Issuance, 2005-2014, EUR m



Source: EMF-ECBC

Issuers: Aktia Bank, Aktia Real Estate Mortgage Bank, Danske Bank, Nordea Bank Finland, OP Mortgage Bank, Alandsbanken.

ECBC Covered Bond Comparative Database: http://ecbc.eu/framework/19/Finland.

Covered Bond · Label · : Danske Bank Plc Pool 1; Nordea Bank Finland cover pool; OP Mortgage Bank, Pool B.

3.11 FRANCE

Three main covered bond issuing structures exist in France today:

> *Sociétés de crédit foncier*;

> *Sociétés de financement de l'habitat*; and

> *Caisse de Refinancement de l'Habitat*.

Previously registered French structured covered bond issuers that had not applied for their conversion into *société de financement de l'habitat* can also continue their activities.

Regulation of *société de crédit foncier ("SCF")* and *sociétés de financement de l'habitat ("SFH")* was substantially strengthened in 2014 by Decree n° 2014-526 dated 23 May 2014 and *Arrêté* dated 26 May 2014.

A – SOCIETE DE CREDIT FONCIER (SCF)

By Francis Gleyze, Caisse Centrale du Crédit Immobilier de France

I. FRAMEWORK

While several countries allow ordinary credit institutions to issue covered bonds subject to the segregation of the cover pool in their balance sheet, France requires the set-up of an *ad hoc* company – the *SCF* – totally distinct from the other companies of the group to which it belongs and exclusively dedicated to the issuance of covered bonds named *obligations foncières (OFs)* and the management of the assets backing those issues (the "cover pool").

The *SCF* is governed by Articles L.513-2 et *seq.* and R.515-2 et *seq.* of the French Monetary and Financial Code (the "Code"). This stringent legal framework is specially designed to protect the holders of the *OFs* it issues.

The *SCF* is also governed by French general banking regulations.

II. STRUCTURE OF THE ISSUER

The *SCF is a* credit institution licensed by the *Autorité de Contrôle Prudentiel et de Résolution (ACPR)*, the French Banking Authority, with a single purpose: to grant or acquire eligible cover assets, as defined by Law, and to finance them by issuing *OFs*, which benefit from a special legal privilege (the "Privilege"). It may also issue or contract other debts benefiting or not from the Privilege.

The *SCF* operates under the close control of the ACPR, which requires it to comply with strict management rules in order to ensure control over risks.

Furthermore, and in addition to the nomination of two external auditors as all French credit institutions, the *SCF* is also required to appoint an independent controller (the "Specific Controller") whose mission, beyond the single monitoring of the cover pool, is more globally to ensure that the *SCF* complies with the regulations and especially with the coverage ratio requirement and the assets/liabilities matching.

III. COVER ASSETS

Only eligible assets, restrictively defined by law, are authorized on the balance sheet of the SCF. All assets on the balance sheet are part of the cover pool.

Assets eligible to the cover pool are:

- loans guaranteed by a first-ranking mortgage or by an equivalent guarantee;
- loans granted to finance real estate and guaranteed by a credit institution or an insurance company with shareholders' equity of at least EUR 12 m and that is not a member of the group to which belongs the *SCF*. The amount of these loans cannot exceed 35% of the assets of the *SCF*;
- public exposures that are totally guaranteed by:
  a) Central administrations, central banks, public local entities and their grouping, belonging to a Member State of the European Union (EU) or a country of the European Economic Area (EEA), or under rating conditions – central administrations and central banks belonging to a non-EU/EEA country;

  b) European Union, International Monetary Fund, Bank for international Settlements and multilateral developments banks registered by the French Ministry of Finance;

  c) Other public sector entities and multilateral development banks as described in Article L.513-4 of the Code;
- senior securities issued by French securitisation vehicles or equivalent entities subject to the law of an EU/EEA country, USA, Switzerland, Japan, Canada, Australia and New Zealand whose assets are composed, at a level of at least 90%, of loans and exposures directly eligible to the cover pool. The assets of the securitisation vehicles or equivalent entities may only consist of mortgage loans or public sector exposures, and under no circumstances, may be backed by assets created by consolidating or repackaging multiple securitisations. To be eligible to the cover pool, the senior securities issued by the securitisation vehicles or similar entity must qualify as a minimum for the credit quality assessment step 1 by a rating agency recognised by the Banque de France.

  Such senior securities cannot exceed 10 % of the nominal amount of the outstanding issue. However, until 31 December 2017, the 10 % limit shall not apply, provided that:

  - the loans carried by the securitisation vehicles were originated by a member of the same consolidated group of which the issuer of the covered bonds is also a member or by an entity affiliated to the same central body to which the issuer of the covered bonds is also affiliated (that common group membership or affiliation to be determined at the time the senior securities are made as collateral for covered bonds); and
  - a member of the same consolidated group, of which the issuer of the covered bonds is also a member or an entity affiliated to the same central body to which the issuer of the covered bonds is also affiliated, retains the whole first loss tranches supporting those senior securities.
- mortgage promissory notes representing loans that would be otherwise directly eligible to the cover pool and issued in accordance with Articles L.313-42 et seq. of the Code. The mortgage notes may not represent more than 10% of the assets of the *SCF*;
- liquid and secured assets (the "substitution assets") up to 15 % of the amount of the outstanding covered bonds issued by the *SCF*. Substitution assets are: securities, assets and deposits for which the debtor is a credit institution or an investment company qualifying for the step 1 credit quality assessment (with a maturity up to 100 days for a credit institution or an investment company subject to the law of an EU/EEA country and qualifying for the step 2 credit quality assessment).

Loans guaranteed by a first-ranking mortgage or by an equivalent guarantee and loans guaranteed by a credit institution or an insurance company are eligible for privileged debt financing up to a part of the financed or pledged real estate value. Senior securities of securitisation vehicles are subject to similar rules.

IV. VALUATION AND LTV CRITERIA

Loans in the cover pool can be financed by *OFs* and other privileged debt up to the amount of:

- the remaining principal balance of the loan; or
- the value of the real estate financed or given as collateral multiplied by the financing coefficient,

whichever is lower.

This financing coefficient is equal to:

- 60% of the value of the financed real estate for guaranteed loans, or of the assets given as collateral for residential mortgages;
- 80% of the value of the real estate in the case of loans that were granted to individuals either to finance the construction or purchase of a home, or to finance both the acquisition of the undeveloped land and the cost of building the home;
- 100% of the value of the real estate financed, in the case of loans guarantied by the *Fonds de garantie à l'accession sociale* (Guaranty Fund for Social Home Accession).

The real estates financed by the loans are valued according to the French mortgage market accepted practice. The real estates values are based on the index provided by INSEE *(Institut National de la Statistique et des Études Économiques)* or on the index provided by Notaries (PERVAL). The real estates are revaluated on an annual basis.

Real estate valuations must be based on their long-term characteristics. Under banking regulation N° 97-02, real estate values are considered as part of the risks of *sociétés de crédit foncier*. The valuations are made by independent experts in compliance with banking regulation.

Among his duties, the Specific Controller controls the eligibility, composition and valuation of the assets.

V. ASSET/LIABILITIY AND RISK MANAGEMENT

The *SCF* must comply with asset/liabilities rules as required by banking regulations and, in particular, it is required to match its assets and liabilities in terms of interest rates and maturities.

Market risks

The *SCF* must manage and hedge market risks on its assets, liabilities and off-balance sheet items: interest rate risks, currency risks, liquidity and maturity mismatch between liabilities and assets. The surveillance of these points is part of the duties of the Specific Controller.

Coverage ratio – overcollateralization

At all times, the total value of the assets of the *SCF* must be, at least, after weighting, equal to 105% of the liabilities benefiting from the Privilege.

From a regulatory standpoint, the coverage ratio is calculated on the basis of the *SCF* accounting data by applying different weights to classes of assets:

- loans secured by a first-ranking mortgage or by an equivalent guarantee are weighted 100% up to their part eligible for privileged debt financing;
- loans guaranteed by a credit institution or an insurance company are weighted 100% if the guarantor qualifies, at least, for the step 2 credit quality assessment, weighted 80% if it qualifies for the step 3 credit quality assessment, and weighted 0% in any other case;
- public exposures and replacement assets are weighted 100%; and

- senior securities of securitisation vehicles are weighted 100%, 80%, 50% or 0% subject to different criteria including, essentially, their rating.

The coverage ratio is reported and published at regular intervals, in accordance with the applicable laws and regulations.

Maturity mismatch

Under the new *Arrêté* dated 26 May 2014, the remaining weighted average life of the assets of the *SCF* should not exceed that of the covered bonds by more than 18 months. Cover pool assets taken into account are only those that are strictly necessary to satisfy the minimum legal overcollateralization requirement of 105%. The ACPR has given a delay until 31 December 2015 for the existing *SCF* to comply with this maturity requirement. In addition, new issuers and structures in run off might be exempted of this requirement.

Liquidity risk

The *SCF* is required to ensure that its cash needs are constantly covered over a moving period of 180 days. The scope of this new obligation will extend to forecasted principal and interest flows involving the *SCF's* assets, as well as to flows related to its derivative instruments. Cash needs may be covered, if necessary, by replacement securities, assets eligible for Bank of France refinancing, and repurchase agreements with credit institutions that have the highest short-term credit ratings or whose creditworthiness is guarantied by other credit institutions that have the highest short-term credit ratings.

The *SCF* is authorized to subscribe to its own *OFs* up to 10% of total privileged liabilities provided that these *OFs* are only used as collateral with the central bank or cancels them within 8 days.

Exposure on the group to which belongs the SCF

New Decree N° 2014-526 and *Arrêté* dated 26 May 2014 limits the ability of the *SCF* to hold assets in the form of exposures on entities of the group to which it belongs. In this aim, when these assets exceed 25% of the non-privileged assets of the *SCF*, the difference between the exposure on these entities and the sum of 25% of the non-privileged assets together with the assets received in guarantee, pledged or full property, is deducted from the numerator of the coverage ratio.

General risks

As credit institution on general, the *SCF* is subject to the banking regulation N° 97-02 on internal control. Accordingly, it must set up a system for monitoring transactions and internal procedures, a system for handling accounting processes and data processing, as well as risk management and monitoring systems.

VI. TRANSPARENCY

As credit institution and listed company, the *SCF* must issue periodic financial information and, in accordance with French regulation N°97-02, a report on risk management.

Moreover, the *SCF* is also required to publish:

- A quarterly report relating to the nature and the quality of their assets. This report must be published in the *Bulletin des Annonces Légales Obligatoires*, in any newspaper enable to publish legal announcements or on the SCF website;
- An annual report describing:
  (i) the nature and the quality of their assets, the characteristics and breakdown of loans and guaranties, the amount of defaults, the breakdown of receivables by amount and by class of debtors, the proportion of early redemptions, the list and characteristics of senior securitisation securities and RMBSs they hold, the volume and breakdown of replacement securities they hold, and

(ii) the extent and sensitivity of their interest-rate exposure. This report is published in the *Bulletin des Annonces Légales Obligatoires* after the annual shareholders' general meeting;

> A quarterly report, on 31 March, 30 June, 30 September and 31 December of each year relating to:

(i) the amount of its coverage ratio and the compliance with the limits they are requested to respect i.e. the 35% limit of guaranteed loans, the 10% limit of mortgage promissory notes etc.;

(ii) the data of the calculation of the coverage of its liquidity needs;

(iii) the gap of the average duration between those of its eligible assets and its privileged liabilities;

(iv) the valuation of the coverage of the privileged debts until their maturity by the available eligible assets and the estimation of the future new production of these eligible assets on the basis of prudent assumptions.

VII. COVER POOL MONITOR AND BANKING SUPERVISION

The Specific Controller is appointed by the *SCF* with the agreement of the ACPR. To ensure his independence, the Specific Controller may not be an employee of either of the *SCF's* independent auditors, of the company that controls the *SCF*, or of any company directly or indirectly controlled by a company that controls the *SCF*.

The mission of the Specific Controller involves the following verifications:

> that all assets granted or acquired by the *SCF* are eligible to the cover pool, and in the case of mortgage assets, that they are properly valued;

> that the coverage ratio is, at any moment, at least, at 105%;

> that the *SCF* comply with all the limits required by the regulation (i.e. the limit of the loans guaranteed by a credit institution or an insurance company, the limit of the mortgage promissory notes and the limit of the replacement assets);

> that the "congruence", i.e. the adequacy of maturities and interest rates of assets and liabilities, is at a satisfactory level, and

> that, on general, the *SCF* complies with the law and regulations.

The Specific Controller certifies that the *SCF* complies with the coverage ratio rules on the basis of a quarterly issuance program, and for any issue of privileged debt of an amount equal or above EUR 500 m. These coverage ratio affidavits are required to be stipulated in issuance contracts where the debt benefits from the Privilege.

The Specific Controller reports to the ACPR. He attends shareholders' meetings, and may attend Board meetings.

Pursuant to Article L.513-23, the Specific Controller is liable towards both the *SCF* and third parties for the prejudicial consequences of any breach or negligence he may have committed in the course of his duties.

The *SCF* operates under the constant supervision of the ACPR.

Its management, its Specific Controller and its Independent Auditors should be agreed by the ACPR.

All the above-mentioned reports should be sent to the ACPR together with the annual report of the Specific Controller and the report of the annual reports of the Independent Auditors.

VIII. SEGREGATION OF COVER ASSETS AND BANKRUPTCY REMOTENESS OF COVERED BONDS

Pursuant to Article L.513-11 of the Code, holders of *OFs* and other privileged debts have preferred creditor status and the right to be paid prior to all other creditors who have no rights to the assets of the *SCF* until the claims of preferred creditors have been satisfied in full.

This Privilege which supersedes the ordinary French bankruptcy law, has the following characteristics:

> The sums deriving from the loans, exposures, similar debts, securities, financial instruments after settlement if applicable, and debts resulting from deposits made with credit institutions by the *SCF* are allocated in priority to servicing payment of the covered bonds and other privileged debt;

> The judicial reorganisation or liquidation or amicable settlement of a *SCF* does not accelerate the reimbursement of *OFs* and other debt benefiting from the Privilege which continue to be paid at their contractual due dates and with priority over all other debts. Until the holders of privileged debts are fully paid off, no other creditor of the *SCF* may avail itself of any right over that company's property and rights;

> The common provisions of French bankruptcy law affecting certain transactions, which entered into force during the months prior the insolvency proceedings (the *période suspecte*), are not applicable to *sociétés de crédit foncier*.

As an exception to the general French bankruptcy law, bankruptcy proceedings or liquidation of a company holding share capital in a *SCF* cannot be extended to the *SCF*. As a result, the *SCF* is totally bankruptcy remote and enjoy full protection from the risks of default by their parent company or the group to which it belongs.

IX. RISK- WEIGHTING AND COMPLIANCE WITH EUROPEAN LEGISLATION

The legislation when taken together with the practices, processes and procedures across the industry should fall within the criteria of Article 129 of the Capital Requirements Regulation (CRR).

OFs comply with the requirements of Article 52(4) of the UCITS Directive and Article 129(1) CRR.[1]

OFs have a 10% risk-weighting according to the Standardised Approach in the CRR.

X. ADDITIONAL INFORMATION

Covered bonds liquidity

The French *sociétés de crédit foncier* which issue jumbo *OFs* have together signed with more than 20 banks a specific standardised market-making agreement, which has become a national agreement.

[1] Please click on the following link for further information on the UCITS Directive and the Capital Requirements Regulation (CRR): http://ecbc.hypo.org/Content/default.asp?PageID=504#position.

B – CAISSE DE REFINANCEMENT DE L'HABITAT (CRH)

By Henry Raymond, Caisse de Refinancement de l'Habitat

I. FRAMEWORK

CRH was created in 1985 by French Government with State explicit guarantee as a central agency in order to refinance French banks in the specific legal framework of art 13 of law 85-685 of July 1985.

Up to the creation of SFEF (*Société de financement de l'économie française*) in October 2008, no other agency of that type was created in France. Since 1 January 2010 up to 31 December 2014, CRH has been appointed to control debt' service and collateral administration of the SFEF.

Today, instead of State guarantee, the French law gives to CRH's bondholders a very strong privilege on CRH's secured loans to banks.

The *Caisse de Refinancement de l'Habitat* (previously *Caisse de Refinancement Hypothécaire*) is a specialised credit institution of which the sole function is to fund French banks housing loans to individuals granted by French banking system.

CRH issues bonds and lends the borrowed amount to banks in the same conditions of rate and duration.

CRH loans take the form of promissory notes issued by the borrowing banks and held by CRH.

CRH's bonds are strictly regulated in order to offer bondholders a very high credit quality and benefit from a legal privilege.

They are governed by the Article 13 of act 1985-695 of 11 July 1985 as complemented by Article 36 of act 2006-872 of 13 July 2006.

CRH received approval to issue bonds under Article 13 of act 1985-695 by letter of 17 September 1985 from the Minister for the Economy, Finance and Budget.

CRH's operations are governed by the provisions of art L. 313-42 to L. 313-49 of Monetary and Financial Code. CRH's loans to banks, i.e. notes held by CRH, are covered by the pledge of housing loans to individuals. In the case of a borrowing bank default, CRH becomes owner of the portfolio of housing loans without any formality notwithstanding any provision to the contrary.

II. STRUCTURE OF THE ISSUER

Caisse de Refinancement de l'Habitat, a French corporation (*société anonyme*), is a specialised credit institution licensed by virtue of the decision taken on 16 September 1985 by the French Credit Institutions Committee (*Comité des Établissements de Crédit*).

CRH is therefore governed by the provisions of Articles L. 210-1 to L. 228-4 of the French commercial Code and Articles L. 511-1 et seq. of the French Monetary and Financial Code.

Its equity belongs to French banks:

> Crédit Agricole SA – Crédit Lyonnais	37.8 %
> Crédit Mutuel – CIC	31.4 %
> Société Générale	14.2 %
> BNP Paribas	9.6 %
> BPCE	6.6 %
> Others	0.4 %

Every borrower is committed to become a shareholder of CRH with a part in CRH's equity related to the part of its borrowings in CRH's global loans amount. Furthermore, every borrower is committed to supply back up lines to CRH if CRH calls them.

These shareholders-borrowers are among the best European names. Their global market share is roughly 90% of the French Mortgage Market.

III. COVER ASSETS

CRH's loans to banks (represented by promissory notes) are covered by the pledge of eligible loans kept in balance sheets of borrowing banks.

Eligible loans are only home loans to individuals defined by law: first-ranking mortgages or guaranteed loans.

The cover pool which include exclusively residential loans are compliant with the Capital Requirements Regulation (CRR) and secured by first rank mortgages (80 % area of the pool) or, under certain conditions by guarantees (de facto 20 % of the pool).

Guaranteed loans are loans with the guarantee of a credit institution or an insurance company (the total amount of these loans cannot exceed 35% of the covering portfolio).

CRH's internal rules only allow French residential loans with maturity under 25 years and size under EUR 1 million.

The total value of the cover pool must equal at least 125% of the total amount of CRH loans (equal to the total amount of CRH bonds) – 150% if floating rate loans.

The geographical area for eligible loans is the European Economic Area (EEA) in the law but CRH's by-laws restrict that area to France and overseas territories only. Public sector assets are not eligible.

No replacement assets are allowed. RMBS and other loans are not eligible.

IV. VALUATION AND LTV CRITERIA

The rules for real estate valuations are the same as those of *sociétés de credit foncier*.

All buildings financed by eligible loans are the subject of a prudent evaluation that excludes all speculative aspects. It is carried out by the borrowing bank.

This valuation must be performed by an independent expert, i.e. a person who is not part of the lending decision-making process.

The valuation is performed taking into account the building's long-term characteristics, normal and local market conditions, the current use made of the asset and all other uses that might be made.

The valuation of the buildings is re-examined as part of the risk measurement system required of borrowing credit institutions by CRBF Regulation no. 97-02. This examination is performed annually using statistical methods.

Loan to value must not exceed 80% (de facto 90% because of the over-sizing of the covering portfolio by 25%).

V. ASSET – LIABILITY MANAGEMENT

CRH's debts and loans (represented by notes) have exactly the same characteristics. CRH is not submitted to an interest rate risk. CRH is not affected by early repayment of loans included in the portfolio.

According to CRH internal regulation, the cover pool must be congruent with rate and duration of CRH's debt to protect CRH in the case where it becomes owner of the cover pool.

VI. TRANSPARENCY

Every year, the annual report publishes the size of the cover pool. This report confirms the characteristics (nature and quality) of home loans pledged and that CRH is not exposed to interest rate risk.

For being compliant with the ECBC Label, CRH releases on a quarterly basis data information on its cover pool required by the National Transparency Template.

VII. COVER POOL MONITOR AND BANKING SUPERVISION

CRH is an independent credit institution that doesn't borrow for its own account but for the account of banks and doesn't charge any fee or interest margin on its refinancing transactions.

CRH regularly achieves, based on sampling, audits on the cover pool, carried out at the borrowing banks. If necessary, CRH asks borrowing banks to increase the cover pool to compensate for the shortfall identified or to pay back CRH by delivering CRH's bonds.

As a credit institution, CRH operates under the general supervision of the French banking authority *l'Autorité de contrôle prudentiel et de résolution* and since November 2014 under direct ECB's supervision. Furthermore, its operations are under a specific supervision of *l'Autorité de contrôle prudentiel et de résolution* because of the provisions of the article L.313-49 of Monetary and Financial Code.

CRH is also subject to audit by its shareholder banks.

VIII. SEGREGATION OF COVER ASSETS AND BANKRUPTCY REMOTENESS OF COVERED BONDS

In the case of a borrowing bank default, CRH becomes owner of the portfolio of housing loans without any formality notwithstanding any provision to the contrary.

CRH is a company independent from borrowing banks. Bankruptcy proceedings or liquidation of a borrowing bank, holding CRH's equity, cannot be extended to CRH.

IX. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

CRH's debt is Aaa rated by Moody's. CRH's covered bonds are AAA rated by Fitch.

CRH's bonds are compliant with the criteria of Article 129(1) CRR and Article 52(4) of the UCITS Directive.[1] They are 10% weighted in standard approach.

They are included in securities accepted for the European Central Bank (ECB) open market operations.

X. ADDITIONAL INFORMATION

CRH belongs to covered bonds world but is very different from other issuers:

> CRH is a former agency created by French government,

> CRH is regulated by specific legal framework dedicated to it,

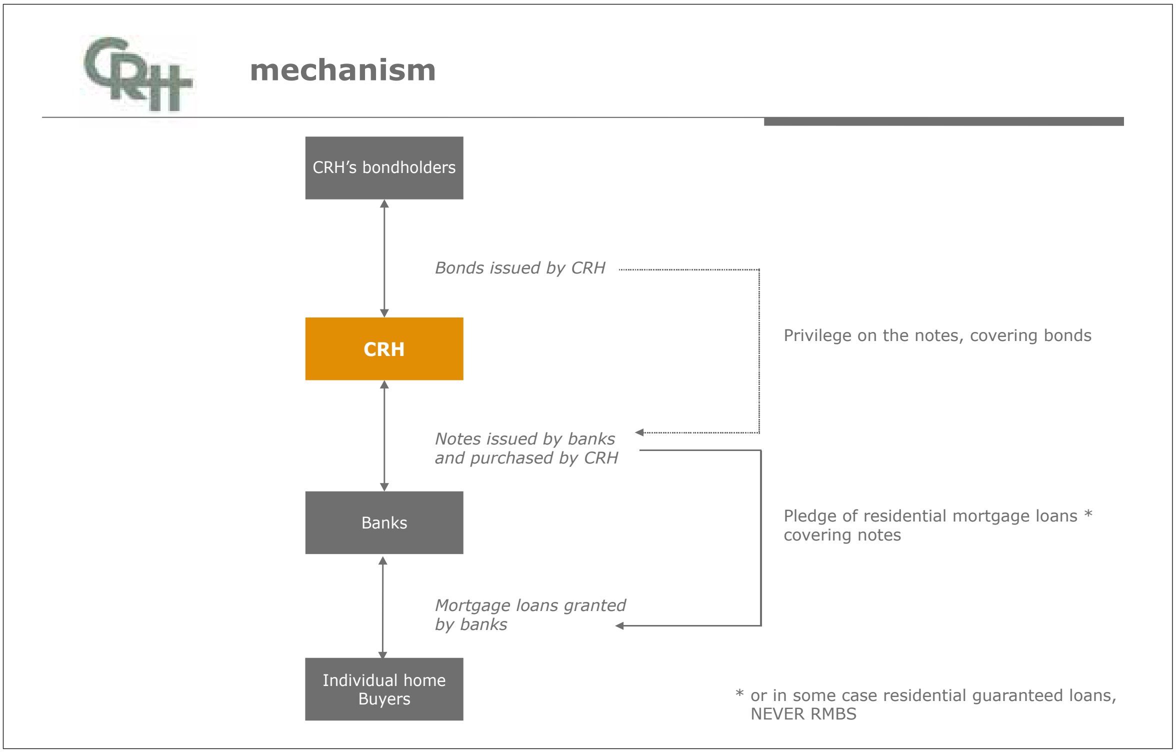
> CRH is not borrowing for itself but for the account of French Banking system,

> CRH is a credit institution of full exercise able to refuse to fund a shareholder,

> CRH benefits from cross commitments of French's banks to supply cash advances and capital contributions.

[1] Please click on the following link for further information on the UCITS Directive and the Capital Requirements Regulation (CRR): http://ecbc.hypo.org/Content/default.asp?PageID=504#position.

Figure 1: CRH Mechanism



mechanism

CRH's bondholders

Bonds issued by CRH

Privilege on the notes, covering bonds

CRH

Notes issued by banks and purchased by CRH

Banks

Pledge of residential mortgage loans * covering notes

Mortgage loans granted by banks

Individual home Buyers

* or in some case residential guaranteed loans, NEVER RMBS

C – OBLIGATIONS DE FINANCEMENT DE L'HABITAT

By Cristina Costa, Société Générale, Boudewijn Dierick, BNP Paribas, Moderator of the ECBC Task Force on Long-Term Financing & Chairman of the ECBC Rating Agency Approaches Working Group and Jennifer Levy, Natixis

The *Société de Financement de l'Habitat* (SFH) and the *Société de Crédit Foncier* (SCF) are subject to the same law and regulations (specific controller, coverage ratio, liquidity ratio, etc.) implemented in the French Monetary and Financial Code (the Code). The segregation of assets is based on the European Collateral Directive which has been transposed into the French Monetary and Financial Code. The SCF/SFH framework was amended in May 2014[1] to increase legal minimum collateralization to 105% (from 102%) and provide further details on exposure to the sponsor bank, maximum asset liability mismatch and liquidity buffer rules.

Under the SFH legislation, the holders of the *Obligations de Financement de l'Habitat* (OH) benefit from a legal privilege granted over the SFH programme's assets (according to article L. 513-11 of the Code). If the issuer becomes insolvent, the OHs and other privileged debts are paid in priority and in accordance with their payment schedule, over any of the programme's other debts or non-privileged creditors in relation to the SFH's assets.

I. FRAMEWORK

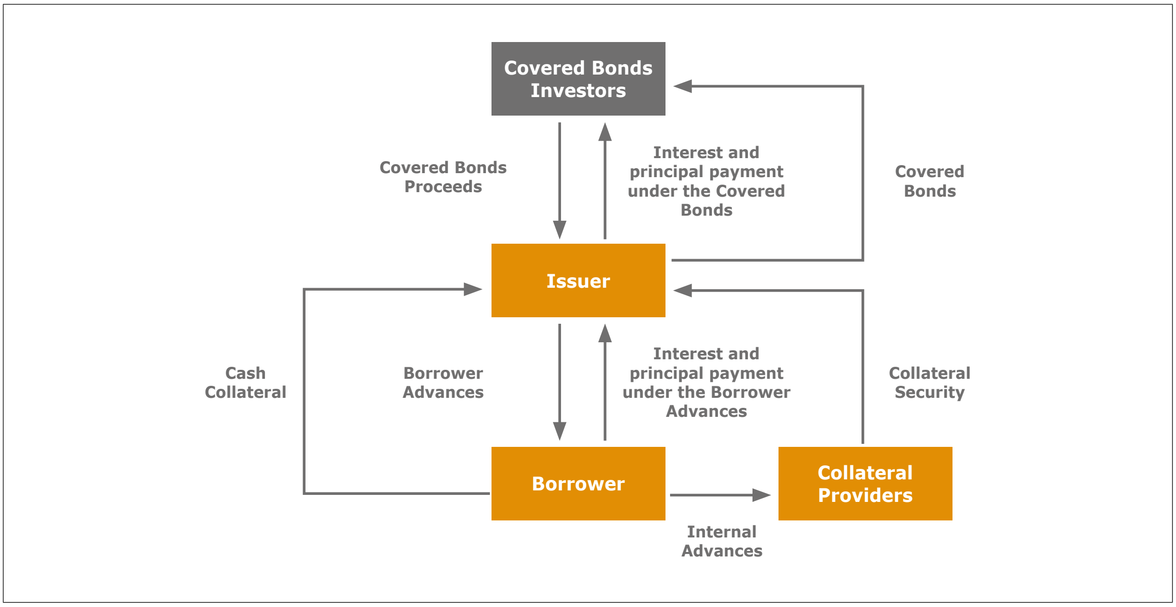
The SFH structure makes use of the implementation of the EU Collateral Directive 2002/47/EC, as amended, under French law (implemented into the Code under articles L. 211-36 and seq.), which allows for a segregation through a specific pledge of the assets without an actual transfer (true sale) of assets to the issuer. Pursuant to article L.211-38 of the Code, the pledge shall be enforceable even when the relevant collateral provider is subject to an insolvency proceeding.

The sponsor bank pledges or assigns collateral to a dedicated subsidiary, which is a regulated French specialised credit institution with limited purpose licensed as a SFH (e.g. issuing covered bonds for the purpose of providing financing to the sponsor bank). The covered bond proceeds are used to fund advances to the respective sponsor bank(s). The covered bonds are secured by the legal privilege over the assets of the issuer (advances to the sponsor bank(s)), which are in turn secured by a pledge over cover assets (i.e. residential home loans), which remain on the sponsor bank's balance sheet (and/or on the balance sheets of the respective subsidiaries, affiliates or group member banks). Upon a borrower enforcement notice (for example in case of default of the sponsor bank), the respective cover assets, including underlying securities, will be transferred without any formalities to the covered bond issuer.

All the French OH issuers choose the dual structure.

[1] http://www.legifrance.gouv.fr/affichTexte.do;jsessionid=?cidTexte=JORFTEXT000028970057&dateTexte=&oldAction=dernierJO&categorieLien=id, JORF n°0121 du 25 mai 2014.
http://www.legifrance.gouv.fr/affichTexte.do;jsessionid=?cidTexte=JORFTEXT000028990539&dateTexte=&oldAction=dernierJO&categorieLien=id, 8551, JORF n°0123 du 28 mai 2014.

Figure 1: Structure of Obligation de Financement de l'Habitat (Dual Structure)


Covered Bonds Investors
Covered Bonds Proceeds
Interest and principal payment under the Covered Bonds
Covered Bonds
Issuer
Cash Collateral
Borrower Advances
Interest and principal payment under the Borrower Advances
Collateral Security
Borrower
Collateral Providers
Internal Advances

Sources: Moody's, Natixis

II. STRUCTURE OF THE ISSUER

The sole purpose of SFH is to grant or to finance home loans and to hold securities or instruments under the conditions set out by the law and financial regulations. Under a SFH programme (EMTN), the SFH issues *Obligations de Financement de l'Habitat* (OHs) which are unsubordinated senior secured obligations and rank pari passu among themselves benefiting from the legal privilege.

These specialised credit institutions are usually an affiliate of the sponsor bank. There are currently eight SFH issuers: BNP Paribas Home Loan SFH (99.9% owned by BNP Paribas), BPCE SFH (99.9% owned by BPCE S.A.), Crédit Mutuel Arkea Home Loans SFH (affiliate of the Crédit Mutuel Arkéa group), Crédit Mutuel-CIC Home Loan SFH (a subsidiary of Banque Fédérative du Crédit Mutuel), Crédit Agricole Home Loan SFH (99.9% owned by Crédit Agricole S.A.), HSBC SFH (France) (a subsidiary of HSBC France), La Banque Postale HL SFH (a subsidiary of La Banque Postale) and Société Générale SFH (a subsidiary of Société Génerale).

III. COVER ASSETS

Pursuant to the SFH Law, the eligible assets of a SFH comprise, inter-alia:

> Home loans (*prêts à l'habitat*) which include (i) loans secured by a first-ranking mortgage or other real estate security interests that are equivalent to a first-ranking mortgage (*hypothèque de premier rang ou une sûreté immobiliere conferant une garantie au moins equivalente*[2]) or (ii) loans that are guaranteed by a credit institution or an insurance company (*cautionnement consenti par un établissement de crédit ou une entreprise d'assurance*). The property must be located in France or in any other Member State of the European Union or the European Economic Area (EEA) or in a State benefiting from the highest level of credit assessment;

[2] Article L513-29, II, 2° of the Code.

- Loans guaranteed by the *Fonds de Garantie à l'Accession Sociale à la Propriété* (Guarantee Fund for Social Access to Home Ownership);
- Loans secured by the remittance, the transfer or the pledge of the receivables arising from the home loans referred above;
- Units or notes (other than subordinated units or subordinated notes) issued by French securitisation vehicles, or other similar vehicles governed by the laws of a Member State of the EU or the EEA if (i) their assets comprise at least 90% of secured loans or other receivables benefiting from the same level of guarantees and (ii) such units or notes benefit from the highest level of credit assessment (*meilleur échelon de qualité de credit*) promissory notes (*billets à ordre*); and
- Substitution assets (*valeurs de remplacement*), under certain liquidity and maturity conditions and provided that their aggregate value is up to a maximum amount of 15% of the outstanding covered bonds. The substitution assets of the SFH may include within the 15% limit debt securities (*titres de créances*) issued or guaranteed by public sector entities referred to in paragraph I, 1 to 5, of Article L. 513-4 of the French Monetary and Financial Code (*Code monétaire et financier*);
- Within the limit of the liquidity buffer, in addition to substitution assets, debt securities (*titres de créances*) issued or guaranteed by a central administration of a Member state of the European Union and cash invested on accounts opened within the books of a central bank of a Member State of the European Union which comply with the criteria listed in 1(a) of Article 416 of the Capital Requirements Regulation n°575/2013 dated 26 June 2013.

Under the SFH Law, cover pool assets comprised of units or notes issued by securitisation vehicles (*organismes de titrisation*) are only eligible to support covered bond issuance if they are rated Aa3/AA- or above (100% eligible) or A3/A- or above (50% eligible). ABS/MBS count as collateral within the pool depending on the originator, the rating of the securitisation, and the time at which the securities were acquired by the issuer.

Weightings of ABS/MBS for *Sociétés de Crédit Foncier* and *Sociétés de Financement de l'Habitat*:

If the underlying assets of the ABS/MBS were originated by the group and they were acquired by the issuer after 31 December 2011, the securities count as collateral with the following ratings:

> 100% as long as they are rated Aaa/AAA;

> 80% if the rating is between Aa3/AA- and Aa1/AA+;

> 0% if the rating is below Aa3/AA-.

If the underlying assets of the ABS/MBS were originated by the group and they were acquired by the issuer before 31 December 2011 or after 31 December 2014, the securities count as collateral with the following ratings:

> 100% as long as they are rated Aaa/AAA;

> 50% if the rating is between Aa3/AA- and Aa1/AA+;

> 0% if the rating is below Aa3/AA-.

If the underlying assets of the ABS/MBS were transferred by an institute that is not a member of the same group as the covered bond issuer and they were acquired by the issuer after 31 December 2011 but before 31 December 2017, the securities count as collateral with the following ratings:

> 100% as long as they are rated Aaa/AAA;

> 50% if the rating is between Aa3/AA- and Aa1/AA+;

> 0% if the rating is below Aa3/AA-.

If the underlying assets of the ABS/MBS were transferred by an institute that is not a member of the same group as the covered bond issuer and they were acquired by the issuer before 31 December 2011 but after 31 December 2014, the securities count as collateral with the following ratings:

> 100% as long as they are rated Aaa/AAA;

> 0% if the rating is below Aaa/AAA.

N.B. These weightings are also applicable to *Sociétés de Crédit Foncier*.

The SFH regulation applies a haircut to in-house guarantors: i.e. if the guarantor is a group institution, only 80% of the loan may be included. In addition if the credit rating is in the BBB region (i.e. below A-), the rate of inclusion drops to 80% for external guarantors and 60% for internal guarantors. If the rating of the guarantor is non-investment grade, the guarantee will no longer be recognized and the guaranteed loans may not be included in the cover pool. For more information please refer to the box below.

Weighting of guaranteed home loans for *Sociétés de Financement de l'Habitat*:

When the home loan guarantor is not part of the same consolidation scope as the SFH or the SCF, the weighting is as follows:

- > 100% when the home loan guarantor has at least the second highest level awarded by a rating agency (≥A3/A-/A- by Moody's/S&P/Fitch);
- > 80% when the home loan guarantor has at least the third highest level of quality awarded by a rating agency (≥Baa3/BBB-/BBB- by Moody's/S&P/Fitch);
- > 0% in all other cases.

When the home loan guarantor is part of the same consolidation scope as the SFH, the guaranteed home loans are weighted as follows:

- > 80% when the home loan guarantor has at least the second highest level of quality awarded by a rating agency (≥A3/A-/A- by Moody's/S&P/Fitch);
- > 60% when the home loan guarantor has at least the third highest level of quality awarded by a rating agency (≥Baa3/BBB-/BBB- by Moody's/S&P/Fitch);
- > 0% in all other cases.

IV. VALUATION AND LTV CRITERIA

The properties are valued according to the French mortgage market accepted practice. The property values are indexed to the French INSEE (*Institut National de la Statistique et des Etudes Economiques*) or PERVAL (Notaries) house price index on a quarterly basis. In most programmes, price decreases are fully reflected in the revaluation, while in the case of price increases, a 20% haircut is applied even though this is not required by law. This valuation is assessed in an annual report by the SFH and certified by the specific controller[3].

In order to ensure overcollateralization (far above the 5% minimum required by law), the SFH programmes also include a dynamic Asset Coverage Test (ACT) that requires the balance of the mortgages in the collateral pool to significantly exceed the balance of the outstanding covered bonds. The minimum level of OC will depend on the credit quality of the mortgages in the cover pool as assessed by the rating agencies. For all the existing programmes the maximum asset percentage applied in the ACT is 92.5%, which translates into a minimum overcollateralization of at least 8%. However, that being said all SFH programmes currently exceed the minimum amount due to adjustments to the most recent rating agency methodologies.

When calculating the appropriate loan balance within the Asset Coverage Test (ACT), higher LTV loans are included in the pool, but loan amounts exceeding the respective cap do not get any value in the ACT. For all programmes, the LTV ratio of the mortgage loans cannot be more than 100%. In addition, the ACT gives no value to the loans in arrears or defaults.

V. ASSET-LIABILITY MANAGEMEMT

Overcollateralisation: By law, the SFH framework must maintain a nominal overcollateralisation ratio of 5% on the adjusted cover pool balance at all times. When intra-group loans in the cover pool exceed 25% of the issuer's non-privileged liabilities (i.e. typically the issuer's share capital or any subordinated bonds), a portion of such loans will be excluded from the cover pool for the purpose of calculating the over-collateralisation test.

[3] Pursuant to the ACPR regulation CRBF 99-10.

This limits the risk that covered bond issuers rely on assets directly exposed to the credit quality of their parent or any of their affiliates. For the calculation of this ratio, the SFH must take into account its risk exposure on its sponsor bank up to a limit of 25% of the non-privileged assets.

Liquidity buffer: Also by law, the SFH framework requires the SFH to cover, at all times, its treasury needs over a period of 180 days, taking into account the forecasted flows of principal and interest on its assets and net flows related to derivative financial instruments. It is no longer possible to cover the existing six-month liquidity gap with intragroup liquidity line.

Liquidity: The SFH framework provides further liquidity means by allowing, as a last-recourse funding option, the SFH to subscribe to its own privileged covered bonds – up to 10% of total privileged liabilities – provided that the SFH uses these OH as collateral with the central bank or cancels them within 8 days.

Maturity mismatch test: from 2014 onwards, the remaining weighted average life (WAL) of assets should not exceed that of the covered bonds by more than 18 months. Cover pool assets included in this test are only those that are strictly necessary to satisfy the minimum legal OC requirement of 105%. This new test supplements the pre-existing general maturity matching principle (*principe de congruence des maturités*). New issuers and structures in run off might be exempted of this requirement and the ACPR has given a compliance delay for the issuers to comply with this maturity mismatch test until 31 December 2015.

The SFHs must also submit once a year to the regulator a maturity mismatch forecast cover plan, that has to be verified by the specific controller.

The requirements above are also applicable to SCF.

In addition to the requirements specified by the SFH Law, all French OH programmes include a number of safeguards to hedge interest rate and currency risk, refinancing risk, commingling risk, set–off risk, market risk, etc, as follows:

> Interest rate and currency risks need to be neutralised (the hedging strategy[4]); subject to certain rating triggers, swaps with suitable counterparties have to be entered to ensure that exposure to market risk is properly hedged;

> Liquidity is ensured through a pre-maturity test for hard bullet bonds (designed to ensure that sufficient cash is available to repay the covered bonds in full, on the original maturity date in the event of the sponsor bank's insolvency) and possible maturity extension;

> Cash flow adequacy is secured through the asset-coverage test and the contractual obligation to neutralise any exposure to interest rate and currency risk;

> Commingling risk is mitigated by the hedging strategy and the Collection Loss Reserve Amount;

> Minimum rating requirements in place for the various third parties that support the transaction, including the bank account holder and swap counterparties.

VI. TRANSPARENCY

All French SFH issuers publish information on their cover pools and outstanding covered bonds on their website. French issuers publish two types of reports 1) French Covered Bond Label Reports (national transparency template) and report on the quality of their assets published on a quarterly basis) and 2) Cover pool investor reports (published on a monthly basis). Due to the new regulation, the SFH must disclose (but not publish), on a quarterly basis: i) the overcollateralization ratio, ii) the components of the calculation of the liquidity buffer, iii) the gap between the average life of the assets and liabilities and iv) the forecast cover plan regarding the matching between the assets and the liabilities.

[4] Article L. 513-15 of the Code.

VII. COVER POOL MONITORING & BANKING SUPERVISION

The issuing bank is responsible for the monthly pool monitoring, with the asset coverage test calculation being checked by an independent Asset Monitor (and by the specific controller – some SFH do not have both): under the terms of the asset monitor agreement, the asset monitor tests the calculation of the asset coverage test annually. In case of non-compliance with the asset coverage test or in case the senior unsecured rating of the sponsor bank drops below a predefined trigger rating level, the test has to be performed on a monthly basis. In addition, rating agencies are involved in the programme and re-affirm the ratings of the program upon a pre-defined issuance volume. They also monitor the amount of overcollateralisation required to maintain the triple-A ratings.

Under SFH Law, each issuer has to appoint a Specific Controller (*Contrôleur Spécifique*), and a Substitute Specific Controller (*Contrôleur Spécifique Suppléant*), who are selected from an official list of external auditors and are appointed subject to the prior approval of the ACPR. Their role is to (i) ensure that the issuer complies with the SFH Law (in particular, by verifying the quality and the eligibility of the assets and the cover ratios the issuer has to comply with), (ii) monitor the balance between the issuer's assets and liabilities in terms of rates and maturity (cash flow adequacy) and (iii) notify the issuer and the ACPR if he considers such balance to be unsatisfactory. The Specific Controller remains liable, both as regards the issuer and third parties, for any loss suffered by them, which results from any misconduct or negligence arising in the performance of its duties. The Specific Controller verifies key financial aspects of the activities of the issuer, in particular the extent of the collateral for the covered bonds. He is independent from both the issuer and the sponsor bank. Furthermore, for every issuance with an amount exceeding EUR500m, the specific controller must attest the compliance of the cover ratio on the basis of the quarterly programme of debt issued benefiting from the privilege.

Regulations[5] published by French regulator ACPR in December 2014 detail further reporting obligations of French covered bond (both SCF and SFH) issuers. The new regulations add detail to the calculation of the maximum 18-month asset-and liability maturity matching tests and the liquidity test. Issuers now have to show how 180-day liquidity needs can be covered on a daily basis, rather than just globally over a six-month period. On a quarterly basis, each CB issuer must now provide to the asset monitor and regulator a 'literary report' designed to increase the transparency, consistency and stability of assumptions, thereby improving the effectiveness of the following legal tests: the minimum 105% OC ratio, the minimum 180-day liquidity, the maximum 18-month average life maturity mismatch and the coverage level.

VIII. SEGREGATION OF COVER ASSETS & BANKRUPTCY REMOTENESS

Under the SFH legislation, the holders of the OH benefit from the legal privilege over the SFH programme's eligible assets. If the issuer becomes insolvent, the OHs and other privileged debts are paid in accordance with their payment schedule, and have priority over any of the programme's other debts or non-privileged creditors in relation to the programme's assets. All privileged debts rank *pari passu*.

The issuer may be subject to insolvency, but the SFH law provides for a regime which derogates in many ways from the French insolvency provisions (the same applies for the SCF programmes):

> **Legal Privilege / No acceleration of covered bonds as a result of insolvency of SFH:** in the event of an insolvency proceeding of the SFH (safeguard procedure, judicial reorganization or liquidation), all claims benefiting from the Privilège[6] (including interest) must be paid on their due dates and in preference to all other claims. Until payment in full of all such preferred claims, no other creditors may take any action against the assets of the SFH;

[5] http://acpr.banque-france.fr/fileadmin/user_upload/acp/publications/registre-officiel/Instruction-2014-I-16-modifiant-2011-I-06-de-l-acpr.pdf and http://acpr.banque-france.fr/fileadmin/user_upload/acp/publications/registre-officiel/Instruction-2014-I-17-de-l-acpr.pdf.

[6] Principal and interest of the Covered Bonds benefit from the so called "Privilège" (priority right of payment). As a consequence, and notwithstanding any legal provisions to the contrary, all amounts payable to the issuer in respect of the cover pool and forward financial instruments are allocated in priority to the payments of any sums due in respect of the covered bonds.

Figure 2: Comparison of French covered bonds

	Obligation de Financement de l'Habitat
Legal Framework	French Monetary and Financial Code, Articles L.513-28 to L.513-33, CRBF regulation no. 99-10 of 9 July 1999 Decree no. 2011-205 of 23 February 2011 and the Banking and Financial Regulation Act no. 2010-1249 of 22 October 2010; amendment in Decree no. 2014-526 of 23 May 2014 and Arrêté of 26 May 2014
Issuer	duly licensed specialized credit institution – Société de Financement de l'Habitat (SFH)
Eligible cover pools	> First rank mortgages and guaranteed home loans (commercial real estate loans are not eligible) > State-guaranteed real estate loans > EEA & outside min A-rated max. 20% > Securitization of the above (subject to specific rules and criteria)
Collateralisation	105%*
Legal Privilege	Yes
LTV ratio	> First-rank residential mortgage loans and guaranteed home loans: max. 80% LTV > State-guaranteed real-estate loans: max. 100% LTV
Substitution assets	Max. 15% of
Liquidity	Requirement to cover all cash flows for a period of 180 days, taking on principal and interests on its assets, and cash flows pertaining to existing six-month liquidity gap with intragroup liquidity line.
Investor protection	Overcollateralisation, 180-day liquidity needs coverage and ability mismatch test (remaining WAL of assets should not exceed WAL
Issue's structure/Transfer of assets	True sale of cover assets or loans secured by financial guarantees (articles L.211-38 and seq French Monetary & Financial Code – transposition of "Collateral" Directives)
Supervision	Autorité de Contrôle Prudentiel et de Résolution (ACPR) – one specific Financiers)
UCITS Compliant	Yes
Risk-weighting according to EU Credit institutions	10%**

* When intra group loans in the cover pool exceed 25% of the issuer's non-privileged liabilities, a portion of such loans will be excluded from the cover pool for the purpose of calculating the overcollateralisation test.

** According to Article 129(1)(e) CRR, guaranteed home loans are eligible for preferential treatment subject to the portion of each of the loans having a maximum LTV of 80%, the eligible guarantor has a rating of maximum Credit Quality Step 2 (equivalent to minimum AA-), and where a loan-to-income ratio respects at most 33% when the loan has been granted.

Obligations Foncières	Caisse de Refinancement de l'Habitat
French Monetary and Financial Code, Articles L.513-2 to L.513-27, regulation no. 99-10 of 9 July 1999. Amended by the Decree no. 2011-205 of 23 February 2011, Banking and Financial Regulation Act no. 1249 of 22 October 2010; amendment in Decree no. 2014-526 of 23 May 2014 and arrete of 26 May 2014	French Monetary and Financial Code Articles L.313-42 to 313-49 and Art L.515-14-1, article 13 Law n°85-695 of 11 July 1985
duly licensed specialized credit institution – Société de Crédit Foncier (SCF)	duly licensed specialized credit institution – Caisse de Refinancement de l'Habitat
> First-rank residential mortgage loans > First-rank commercial mortgage loans > State-guaranteed real-estate loans > Third party guaranteed real estate loans (max. 35% of total assets) > Public sector loans, bonds and leasing > Securitization of the above (subject to specific rules and criteria)	> First rank residential mortgage loans > State guaranteed mortgage loans > Third party guaranteed real estate loans (max. 35% of total assets) > No securitisation tranches, no RMBS > No loans with duration over 25 years > No loans with unit amount over €1m
105%*	125%
Yes	Yes
> First-rank residential mortgage loans and guaranteed home loans: max. 80% LTV > First-rank commercial mortgage loans: max. 60% LTV > State-guaranteed real-estate loans: max. 100% LTV	> Residential mortgage loans: max 80% LTV, max 90% LTV if overcollateralisation of 25% > State guaranteed mortgage loans: max 100% LTV
total Privileged debts	Not eligible
into account all cash flows resulting of future payments term instruments. It is no longer possible to cover the	
to repo own issuances, controlled ALM, maturity of covered bonds by more than 18 months)	Overcollateralisation, full recourse to the participating banks in case of collateral shortfall
True sale nearly exclusively (but loans secured financial guarantee for "public exposures" legally possible)	ad hoc promissory notes exclusively secured by eligible cover pools
controler – two auditors – AMF (Autorité des Marchés	Autorité de Contrôle Prudentiel et de Résolution (ACPR) – two auditors – AMF (Autorité des Marchés Financiers)
Yes	Yes
10%	10%

- **No nullity during the hardening period:** the provisions allowing an administrator to render certain transactions entered into during the hardening period (*période suspecte*) null and void are not applicable for the transfer of assets entered into by a SFH (provided that such transactions are made in accordance with their exclusive legal purpose and without fraud);
- **Option to terminate ongoing contracts with insolvent counterparties:** in case of the opening of any insolvency procedure against the credit institution, which is acting as manager and servicer of the SFH, any contract may be immediately terminated by the SFH notwithstanding any legal provisions to the contrary;
- **No consolidation:** SFH law precludes the extension of any insolvency procedure in respect of the SFH's shareholders to the SFH itself.

IX. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

The SFH meet the requirements of Article 52(4) of the UCITS Directive.

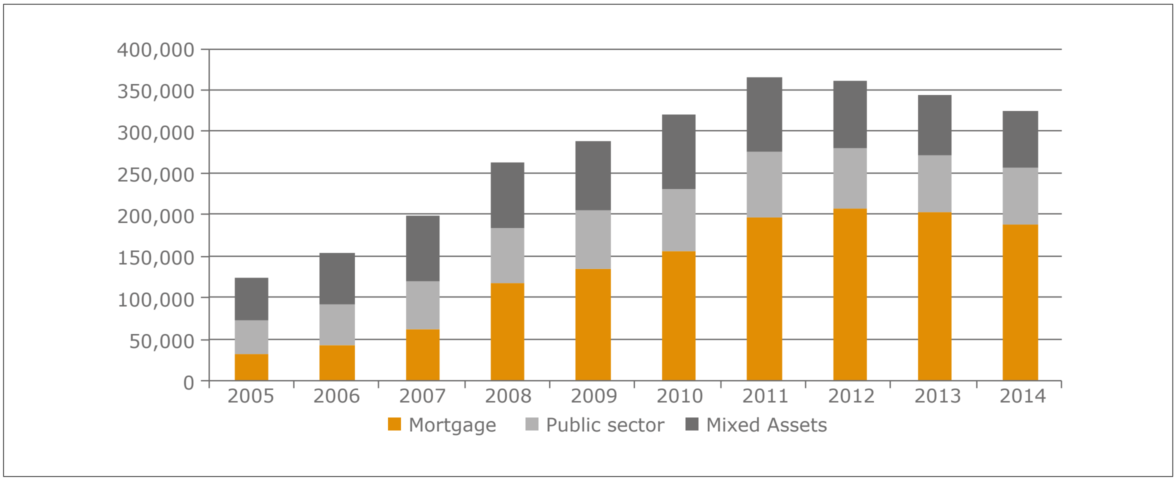
Article 129 CRR defines which assets are eligible as collateral for covered bonds to ensure a lower risk-weighting.[7] French guaranteed home loans (*prêts cautionnés*) are eligible for preferential treatment subject to a number of conditions:

- the eligible guaranteed home loan provider qualifies for credit quality step 2 or above (i.e. rated minimum A3/A-/A- by Moody's, S&P and Fitch);
- the portion of each of the loans that is used to meet the requirement for collateralization of the covered bonds does not represent more than 80% of the value of the corresponding residential property located in France (i.e. guaranteed home loans comply with the 80% LTV limit), and
- where a loan-to-income ratio is limited to 33% when the loan has been granted.

In France and abroad, French OH currently have a 10% risk-weighting under the CRD IV Standard Approach. French OH are also eligible as Level 1 assets to the Liquidity Coverage Ratio (LCR).

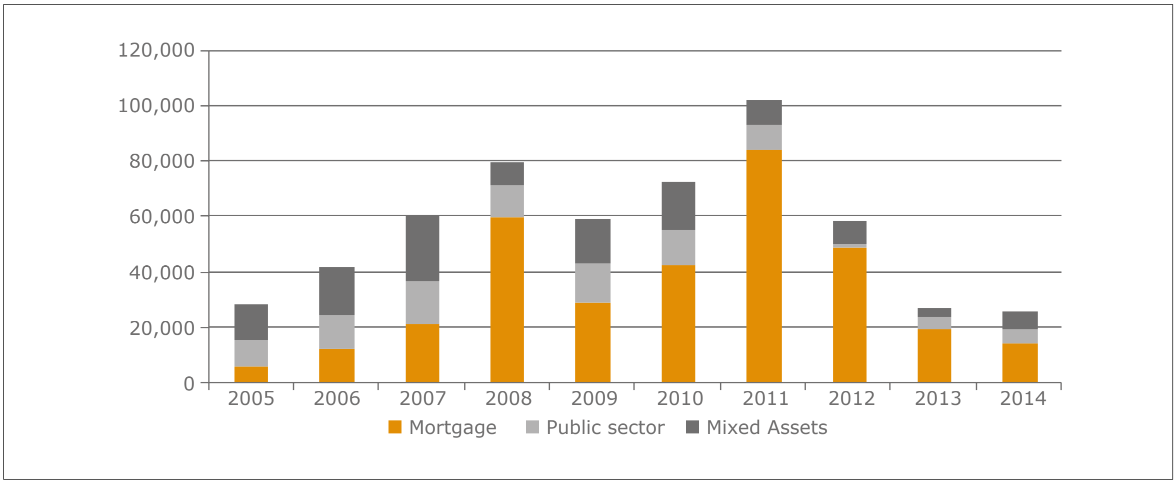
[7] Please click on the following link for further information on the UCITS Directive and the Capital Requirements Regulation (CRR): http://ecbc.hypo.org/Content/default.asp?PageID=504#position.

> Figure 3: Covered Bonds Outstanding, 2005-2014, EUR m



Source: EMF-ECBC

> Figure 4: Covered Bonds Issuance, 2005-2014, EUR m



Source: EMF-ECBC

Issuers: AXA Bank Europe (SCF); BNP Paribas Public Sector (SCF); BNP Paribas Home Loan (SFH); BPCE (SFH); Banques Populaires Covered Bonds (BP CB); Caisse d'Epargne (CNCE CB); Caisse Française de Financement Local (CAFFIL); CIF Euromortgage; Compagnie de Financement Foncier (CFF) ; Crédit Foncier et Communal d'Alsace et de Lorraine (CFCAL) ; Crédit Agricole Public Sector (SCF) ; Crédit Agricole Home Loan (SFH) ; Crédit Mutuel – CIC Home Loan (SFH) ; Crédit Mutuel Arkéa Public Sector (SCF) ; Crédit Mutuel Arkéa Home Loans (SFH) ; Caisse de Refinancement de l'Habitat (CRH) ; GE Money Bank (SCF) ; HSBC (SFH) ; La Banque Postale Home Loan (SFH) ; Société Générale (SCF) ; Société Générale (SFH).

ECBC Covered Bond Comparative Database: http://ecbc.eu/framework/21/Caisse_de_Refinancement_de_l%27Habitat_-_CRH, http://ecbc.eu/framework/71/General_Law_Based_CBs, http://ecbc.eu/framework/73/Obligations_Fonci%C3%A8res_-_OF, http://ecbc.eu/framework/90/Obligations_%C3%A0_l%27Habitat_-_OH.

Covered Bond · Label · : AXA Bank Europe SCF; BNP Paribas Home Loan SFH; BNP Paribas Public Sector SCF; BPCE Home Loan SFH; CRH; Caisse Française de Financement Local; Compagnie de Financement Foncier; Credit Agricole Home Loan SFH; Credit Agricole Public Sector SCF; Crédit Mutuel – CIC Home Loan SFH; Crédit Mutuel Arkéa Home Loan SFH; Crédit Mutuel Arkéa Public Sector SCF; HSBC SFH (France); La Banque Postale Home Loan SFH; SG Credit Public Sector SCF; SG Credit Home Loan SFH.

3.12 GERMANY

By Wolfgang Kälberer, Association of German Pfandbrief Banks & Chairman of the ECBC Fact Book Working Group
and Otmar Stöcker, Association of German Pfandbrief Banks

I. FRAMEWORK

In Germany, the legal basis for covered bond issuance is the German Pfandbrief Act (PfandBG – Pfandbriefgesetz) dated 22 May 2005. It supersedes the general bankruptcy regulation (§§ 30-36a of the Pfandbrief Act).

On 26 March 2009 amendments of the PfandBG came in force introducing a new Pfandbrief category, the Aircraft Pfandbrief, and furthermore enhancing the attractiveness of Pfandbriefe for investors. Among many improvements, a further liquidity safeguard has been implemented by introducing a special liquidity buffer of 180 days. Further amendments came into force on 25 November 2010, on 1 January 2011 and 1 January 2014 in order to strengthen the position of the special cover pool administrator. The last amendment of the PfandBG introduced further transparency requirements in favour of Pfandbrief investors, to be applied from spring 2014 on.

In the end of 2014, legislation on transposing the BRRD into German law was published; this bill contained further amendments of the Pfandbrief Act. The mayor issue is to provide the BaFin with the competence to order higher minimum OC than the legal 2 % (cover add-on).

II. STRUCTURE OF THE ISSUER

Since 2005, the issuer of Pfandbriefe is no longer required to be a specialised bank. Instead, Pfandbrief issuers are allowed to exercise all activities of a credit institution, although a special licence for Pfandbrief issuance is required. The minimum requirements to obtain and keep the special licence are as follows:

> Core capital of at least EUR 25 million

> General banking licence which allows the issuer to carry out lending activities

> Suitable risk management procedures and instruments

> Business plan showing regular and sustainable issues as well as necessary organisational structure

Since the German outsourcing guidelines of the BaFin do not allow for the outsourcing of important and decision-making sections of the credit institution, the issuer is required to have its own employees. In addition, the PfandBG requires Pfandbrief banks to manage their own risk and take their own credit decisions on their own.

The issuer holds the cover assets on his balance sheet. A subsequent transfer of the cover assets to another legal entity does not take place. Given that a direct legal link between single cover assets and Pfandbriefe does not exist, all obligations relating to Pfandbriefe are obligations of the issuing bank as a whole, to be paid from all the cover assets of the issuer, recorded in the cover register. In the case of insolvency, the cover pool is segregated by law from the general insolvency estate and is reserved for the claims of the Pfandbrief holders. Even then, Pfandbrief holders still have a claim against the general insolvency estate.

III. COVER ASSETS

Cover assets are produced by mortgage lending, public sector lending, ship and aircraft financing activities. ABS/MBS are not eligible. A specific class of covered bonds corresponds to each of these cover asset classes: Hypothekenpfandbriefe, Öffentliche Pfandbriefe, Schiffspfandbriefe and Flugzeugpfandbriefe. The respective Pfandbrief must be fully secured by its specific cover asset class (§ 4 PfandBG). Detailed transparency requirements are regulated in § 28 PfandBG, enhanced by the amendments 2009, 2010 and 2013.

Up to 10% of the nominal volume of Pfandbriefe outstanding may consist of money claims against the European Central Bank, central banks in the European Union or against suitable credit institutions, which fulfil the requirements of credit quality step 1 according to Table 1 of the Annex VI of Directive 2006/48/EC.

The geographical scope of eligible mortgage assets is restricted to EU/EEA countries, to Switzerland, USA, Canada and Japan. Public sector loans to these countries are eligible for the cover of Öffentliche Pfandbriefe (§ 20 PfandBG). In 2014, the mortgage asset scope was enlarged to Australia, New-Zealand and Singapore. The total volume of loans granted in non-EU countries where it is not certain that the preferential right of the Pfandbrief creditors extends to the cover assets, may not exceed 10 % of the total volume of the cover loans (§§ 13 I 2, 20 I 2 PfandBG) and 20 % for ship and aircraft mortgages (§§ 22 V 2, 26b IV PfandBG).

Derivatives are eligible for cover pools under certain conditions. They must not exceed 12% of the cover assets when calculated on a net present value basis (§ 19 I 4. PfandBG).

IV. VALUATION AND LTV CRITERIA

Property valuation is regulated in § 16 PfandBG. This provision refers to the mortgage lending value (Beleihungswert) which is, in contrast to the market value, based on sustainable aspects of the property. Details about the valuation process and the qualifications of valuers are regulated in a specific statutory order on the mortgage lending value (Beleihungswertermittlungsverordnung, BelWertV), § 16 IV PfandBG.

Monitoring requirements result from the Capital Requirements Directive (once a year for commercial real estate and once every three years for residential real estate). In addition, § 26 BelWertV requires a review of the underlying assumptions when the market has declined substantially; a review of property values is also necessary when the loan has defaulted.

The BelWertV requires personal and organisational independence of the valuer (internal or external valuer)

For both commercial and residential property, the LTV limit is 60% of the mortgage lending value of the property. This LTV is a relative limit, i.e. when the loan exceeds the 60% limit, the part of the loan up to 60% LTV remains eligible for the cover pool.

V. ASSET – LIABILITY MANAGEMENT

§ 4 PfandBG stipulates that the total volume of Pfandbriefe outstanding must be covered at all times by assets of at least the same amount. Thus, the nominal value of the cover assets must permanently be higher than the respective total value of the Pfandbriefe.

In addition, the Pfandbrief Act requires that Pfandbriefe are covered on a net present value basis even in the event of severe interest rate changes or currency fluctuations. The issuer has to provide an overcollateralisation of at least 2% after stress tests which have to be carried out weekly. Both the maturity of outstanding Pfandbriefe and the fixed-interest periods of the cover pool are disclosed on a quarterly basis. Details about the calculation are regulated in a special statutory order Net Present Value (Barwertverordnung).

Furthermore, each day Pfandbriefbanks have to calculate the maximum liquidity gap within the next 180 days. This amount has to be covered by liquid assets (§ 4 Ia PfandBG).

Every quarter, the stress-tested NPV of outstanding Pfandbriefe, the cover pool and the over-collateralisation have to be published (§ 28 I PfandBG). The stress tests apply not only to interest rate risks but also to foreign exchange risks.

Cash flow mismatch between cover assets and covered bonds is furthermore reduced by the prepayment rules applicable to fixed interest rate mortgage loans. Prepayments of mortgages during fixed rate periods are only permitted in cases of "legitimate interest" of the borrower or after a period of ten years. If the mortgage is prepaid, the borrower has to compensate the damage of the lender caused by the prepayment (§ 490 II German Civil Code).

VI. TRANSPARENCY

According to § 28 of the Pfandbrief Act (Pfandbriefgesetz, PfandBG), all Pfandbrief Banks are obliged to publish detailed information about their Pfandbrief outstanding and the pertaining cover pools on a quarterly basis. These include

- The total volume of Pfandbrief outstanding as well as the related cover pools in terms of nominal, net present and stressed net present value;
- The share of derivative financial instruments in the cover assets;
- Information on interest rate and currency risk;
- The share of further cover assets, separated between claims against public authorities or claims against credit institutions and separated according to the state in which the debtor is located;
- The maturity structure of the Pfandbrief and cover assets;
- Information on the size of the cover assets;
- Information on the mortgages by property type/type of use, region and state;
- Information on the average LTV and average seasoning;
- Information on the claims against the public sector by state and type of issuer with specific disclosure of exposure guaranteed by Export Credit Agencies;
- Information on the ship mortgages/aircraft registered liens by register country; and
- Information on non-performing cover assets.

The legal transparency requirements are frequently amended in order to increase confidence and security of investors. In 2009, for example, the Pfandbrief Banks pressed for a more detailed disclosure of maturities in order to ensure that investors are better informed about the short and medium-term maturities. The 2010 amendment of the Pfandbrief Act introduced a period of one month after the end of each quarter, in which the quarterly report must be published, except for the fourth quarter, where this period is extended to two months. The 2013 amendment of the PfandBG introduced inter alia further transparency requirements, which have to be applied since spring 2014.

Beside these legal requirements, the vdp member banks started the vdp Transparency Initiative in 2010. Within the scope of this initiative, transparency reports of vdp member institutions are published

- In a uniform format;
- That can be processed electronically;
- Using a uniform understanding of the legal requirements; and
- On one central website (the vdp's).[1]

Each report is available as a reading version in pdf format and, suitable for further direct processing, in xls (Excel) and csv formats as well. Automatic links to investor data bases are possible. The website offers sorting possibilities for the reports both by reporting date and bank name. All reports are published in English and German language versions. There is a data history available that goes back to 31 December 2008. Hence, the vdp Transparency Initiative provides investors with excellent resources to analyse Pfandbrief cover pools pursuant to their specific needs.

[1] http://www.pfandbrief.de/cms/_internet.nsf/tindex/de_pub_pfandbg.htm.

While transparency of cover pools is important for investors, information on covered bonds has to go far beyond cover assets. Another crucial element is transparency regarding the legal structure of covered bonds, which includes information on the legal nature of the cover pool, the segregation of cover assets, the insolvency remoteness of covered bonds, the timely payment in the case of the issuer's insolvency and on the question who actually issues the covered bond. Transparency of these aspects is of utmost importance for investors as covered bonds are designed to survive the issuer's insolvency. The best cover assets will be of no value for the investor if they disappear in the issuer's insolvency estate. The Pfandbrief Act contains detailed regulations of all these aspects, thus ensuring investors a high degree of product transparency.

VII. COVER POOL MONITOR AND BANKING SUPERVISION

BaFin carries out the general banking supervision on German Pfandbrief banks.

In addition, BaFin carries out a special supervision on Pfandbrief banks through a dedicated division. The "Pfandbriefkompetenzcenter" is responsible for all fundamental issues regarding the PfandBG and carries out cover pool audits using own staff or external auditors.

Cover audits

The cover pools are subject to a special audit conducted usually every two years by the supervisory authority (§ 3 PfandBG). Cover pool audits are performed either by the appropriate specialist section at BaFin itself or by suitable auditors, who are mandated via contract by public tender.

A cover audit is conducted in respect of individual cover pool assets, the observance of matching cover requirements in terms of the nominal and net present value calculation, the proper keeping of the cover registers, and the systems and processes in place with regard to the cover pools.

Audits of individual cover assets seek to ensure that the respective assets were included in cover in accordance with the relevant rules and regulations or that their continued inclusion is in line with requirements. These audits are made on the basis of suitable samples, which BaFin defines with the help of extensive information about the composition of the cover pools. Moreover, the audit may concentrate on particular areas if BaFin wishes to focus on specific countries, currencies or types of property use. More than 100 individual cases are audited, depending on the size and composition of the cover pool. Where the loan files are not stored at a central location, and given that the documentation for one individual property finance transaction can fill several dozen ring binders, this calls for intensive logistical preparations in order to limit the – in practice – customary length of the audit to two to three months.

A system audit entails examining all the Pfandbrief bank's main processes and systems that are directly or indirectly linked to the cover assets and the issued Pfandbriefe. In particular, process documentation, system descriptions and the proper implementation of the relevant methods are scrutinized.

Furthermore, a cover pool monitor (Treuhänder) supervises the cover pool. He is appointed by the BaFin and must possess the expertise and experience necessary to fulfil all duties. A qualification as a certified auditor suggests that the necessary expertise is provided.

The monitor has to ensure that the prescribed cover for the Pfandbriefe exists at all times and that the cover assets are recorded correctly in the cover register, §§ 7, 8 PfandBG. Without his approval, no assets may be removed from the cover pool or new Pfandbriefe been issued. The BaFin has published a specific statutory order on details of the form and the contents of this cover register (Deckungsregisterverordnung – DeckRegV), § 5 III PfandBG.

VIII. SEGREGATION OF COVER ASSETS AND BANKRUPTCY REMOTENESS OF COVERED BONDS

A cover register (Deckungsregister) permits the identification of the cover assets, § 5 PfandBG. The register records the cover assets being used to cover the Pfandbriefe as well as claims under derivatives (§ 5 I 1 PfandBG).

The legal effect of registration is that in the case of insolvency of the issuer, the assets which form part of the cover pool can be identified: All values contained in the register would not be part of the insolvency estate. § 30 I 1 PfandBG now calls them "insolvency-free assets".

While the bank carries out the daily administration of the cover register, it is the cover pool monitor who supervises the required cover und registration in the cover register, § 8 I, II PfandBG. Copies of the cover register shall be transmitted to the supervisory authority on a regular basis.

Asset segregation

The cover pool is a part of the general estate of the bank as long as the issuer is solvent. If insolvency proceedings are launched, by operation of law, the assets recorded in the cover registers are excluded from the insolvency estate (§ 30 I 1 PfandBG). Those assets will not be affected by the launching of the insolvency proceedings (§ 30 I 2 2. HS PfandBG).

After the launching of the insolvency proceedings, a special cover pool administrator (Sachwalter) carries out the administration of the cover assets (§ 30 II 1 PfandBG). Through the appointment of the cover pool administrator by the court, on proposal of the BaFin (or by BaFin in case of urgency), the right to manage and dispose of the recorded assets will be transferred to him automatically by law (§ 30 II 2 PfandBG). Regarding cover assets and timely payment of Pfandbriefe, the cover pool administrator represents the Pfandbriefbank (§ 30 II 5, 6 PfandBG). He is allowed to use premises and staff of the Pfandbriefbank (§31 VIII PfandBG).

The cover pool administrator may even be appointed before the insolvency proceedings have been launched (§ 30 V PfandBG).

Impact of insolvency proceedings on covered bonds and derivatives

Covered bonds do not automatically accelerate when the issuing institution is insolvent, but will be repaid at the time of their contractual maturity. The same applies to derivatives which are registered in the cover register and form part of the cover pool. Accordingly, the German master agreements for cover derivatives stipulate that the bankruptcy of the Pfandbrief issuer does not signify a termination event. Article 13 N° 6 DeckregV stipulates that the collateral provided by the derivative counterpart or the Pfandbrief bank has to be registered in the cover register. The consequence of such registration is that the collateral belongs to the insolvency-free assets.

Preferential treatment of covered bond holders

Covered bond holders enjoy preferential treatment as the law stipulates the separation of the cover assets on the one hand and the insolvency estate on the other, § 30 I PfandBG.

The satisfaction of the Pfandbrief creditors is not limited to the cover assets. On the contrary, these creditors also participate in the insolvency proceedings with respect to the Pfandbrief bank's remaining assets.

Only in the case of over-indebtedness or illiquidity of the cover pool, the BaFin may apply for a special insolvency procedure relating to the cover pool and covered bonds (§ 30 VI 2 PfandBG). Insolvency of the cover pool is the only reason, which might trigger acceleration of Pfandbriefe.

Access to liquidity in case of insolvency

Through the appointment of the cover pool administrator, the right to manage and dispose of the recorded assets is transferred to him by law (§ 30 II 2 PfandBG). Thus, the cover pool administrator has first access to the cover assets and collects the cash flows according to their contractual maturity (§ 30 III 2 PfandBG).

No explicit regulation exists with respect to the insolvency remoteness of voluntary over-collateralisation (OC). However, the insolvency administrator may only demand that the over-collateralisation be surrendered to the insolvency estate if those amounts will obviously not be necessary as cover for the respective Pfandbrief category (§ 30 IV 1 PfandBG). The burden of proof that OC will never be necessary for the timely payment of the Pfandbriefe, lays with the insolvency administrator.

The cover pool administrator is entitled to contract loans in order to obtain liquidity. According to § 30 II, 5 PfandBG, the cover pool administrator may carry out legal transactions with regard to the cover pools in so far as this is necessary for an orderly settlement of the cover pools in the interest of the full and timely satisfaction of the Pfandbrief creditors.

Pfandbriefbank with limited business activities

The amendment of the PfandBG 2010 was focused on the legal nature of cover pools in the event of a Pfandbrief bank's insolvency and on the access of a cover pool administrator to liquid funds during difficult times. A cover pool would get automatically the status of a non-insolvent part of the bank of the insolvent Pfandbrief bank. Thus, the cover pool administrator could act as head of a bank in respect of transactions with the Deutsche Bundesbank; he would also be entitled to issue Pfandbriefe.

More precisely, § 2 IV PfandBG stipulates that the banking license will be maintained with respect to the cover pools and the liabilities covered there from until the Pfandbrief liabilities have been fulfilled in their entirety and on time.

A revised version of § 30 PfandBG addressing the ring-fencing of the cover assets from the insolvency estate confirms this new approach by introducing the new heading 'segregation principle' and by referring to the cover assets as 'insolvency-free estates'. Consistently, the amended PfandBG incorporates the term 'Pfandbrief bank with limited business activities'.

Thus, the amendments 2010 ensure that the cover pool administrator acts on behalf of a solvent Pfandbrief bank that is in possession of a license to engage in banking business in general and in Pfandbrief business more specifically, even if the bank itself is insolvent and the general banking license withdrawn. Hence, the Pfandbrief bank with limited business activities is treated as a solvent bank in order to comply with the eligibility criterion "counterparty" for central bank open market operation with the perspective to satisfy its liquidity needs.

Sale and transfer of mortgage assets to other issuers

According to § 32 I PfandBG, the cover pool administrator may transfer all or a part of the assets recorded in the cover register as well as liabilities from Pfandbriefe as a whole to another Pfandbrief bank. This transfer requires the written approval of the supervisory authority.

According to § 35 I PfandBG, the cover pool administrator may also agree with another Pfandbrief bank that the assets recorded in the insolvent Pfandbrief bank's cover register may be managed in a fiduciary capacity by the insolvent Pfandbrief bank's cover pool administrator for the other Pfandbrief bank.

Thus, particular provisions allow for an easy "transfer" of mortgages outside of the common provisions of civil law, e.g. the management in a fiduciary capacity of registered land charges (so called "Buchgrundschulden") and foreign mortgages. Both forms require the written approval of the BaFin.

Since 1 January 2011, § 36a PfandBG stipulates that the specific provisions of the PfandBG have priority during the restructuring of a Pfandbriefe issuing institution according to the new "Restrukturierungsgesetz". The amendments 2013 clarified a few issues regarding the bridge bank solution.

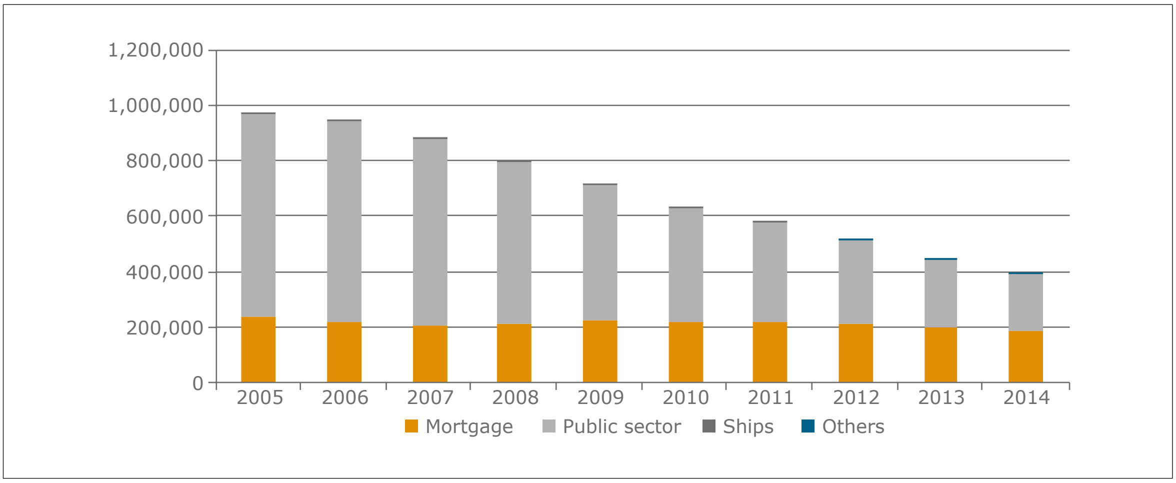
IX. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

The risk-weighting of covered bonds (German Pfandbriefe and foreign covered bonds) is regulated by Art. 129 Capital Requirements Regulation (CRR). Thus, German Pfandbriefe as well as foreign covered bonds complying with the CRR and carrying an external rating of at least AA- will enjoy a 10% risk weight. Cover pool derivatives will not be receiving a preferential treatment under the new framework any more.

Finally, German investment legislation allows investment funds to invest up to 25% of the fund's assets in Pfandbriefe and furthermore in covered bonds issued by credit institutions complying with the requirements of Article 52(4) of the UCITS Directive (Article 60(2) German Investment Act).[2]

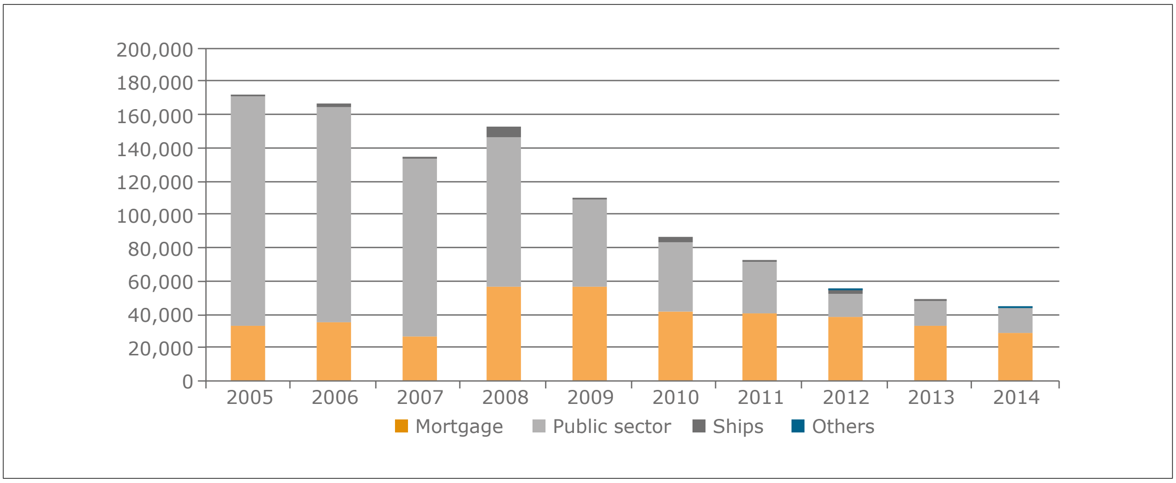
[2] Please click on the following link for further information on the UCITS Directive and the Capital Requirements Regulation (CRR): http://ecbc.hypo.org/Content/default.asp?PageID=504#position.

> Figure 1: Covered Bonds Outstanding, 2005-2014, EUR m



Source: EMF-ECBC

> Figure 2: Covered Bonds Issuance, 2005-2014, EUR m



Source: EMF-ECBC

Issuers: There are currently about 70 Pfandbrief banks in Germany, including banks from all three pillars of the German banking industry (private banks, public banks and co-operative banks). They include 18 former mortgage banks, 10 Landesbanks and circa 30 savings banks. Also, an increasing number of private universal banks became Pfandbrief banks within the last years.

ECBC Covered Bond Comparative Database: http://www.ecbc.eu/framework/23/Pfandbriefe.

Covered Bond Label : NORD/LB; UniCreditBank AG HVB Mortgage; UniCreditBank AG HVB Public.

3.13 GREECE

By Alexander Metallinos, Karatzas & Partners Law Firm

I. FRAMEWORK

In Greece, the primary legal basis for Covered Bond issuance is Article 152 of Law 4261/2014 "On Access to the Activity of Credit Institutions, Prudential Supervision of Credit Institutions and Investment Firms (transposition of Directive 2013/36/EU), Repeal of Law 3601/2007 and Other Provisions", (the "Primary Legislation"). This provision is identical with the provision of Article 91 of the now repealed Law 3601/2007, which had entered into force on 1 August 2007 and therefore the repeal of Law 3601/2007 had no effect on the regulation of covered bonds. The Primary Legislation supersedes general provisions of law contained in the Civil Code, the Code of Civil Procedure and the Bankruptcy Code. By way of implementation of the Primary Legislation and, pursuant to an authorization provided by the latter, the Governor of the Bank of Greece has issued Act nr. 2598/2.11.2007 which was replaced by the Bank of Greece Act nr. 2620/28.8.2009 (the "Secondary Legislation"). Finally, the legislative framework in Greece is supplemented by Law 3156/2003 "On Bond Loans, Securitization of Claims and of Claims from Real Estate" (the "Bond Loan and Securitization Law"), to the extent that the Primary Legislation cross-refers to it.

II. STRUCTURE OF THE ISSUER

The Greek legislative framework permits the issuance of covered bonds in two ways, either directly by a credit institution, or indirectly by a subsidiary of a credit institution. In the direct issuance structure the covered bonds are issued by a credit institution and the segregation of the cover pool is achieved through a statutory pledge over the cover pool assets.

Paragraph 13 of the Primary Legislation allows for a variation to the direct issuance. Under this structure the covered bonds are issued by the credit institution and are guaranteed by a special purpose entity (SPE), which acquires the cover pool. This structure has not yet been used by any issuer.

In the indirect issuance structure the covered bonds are issued by a special purpose entity being a subsidiary of a credit institution, which purchases the cover assets from the credit institution by virtue of the provisions of the Bond Loan and Securitization Law, and are guaranteed by the credit institution.

The reason for introducing the indirect issuance structure was that historically most Greek banks had issued a significant amount of notes under medium term note (MTN) programmes containing negative pledge covenants, which did not allow the creation of security over the cover pool, as is necessary for the direct issuance of covered bonds. However all Greek banks having MTN programmes have now amended the terms of such programmes to carve out the security provided to holders of covered bonds from the scope of the negative pledge covenants, and therefore the need for the indirect issuance of covered bonds has been removed. In fact, the only indirect issuance of covered bonds has now been fully redeemed and it is to be expected that the regulator will likely not approve any future indirect issue of covered bonds.

III. COVER ASSETS

The type of assets that may form part of the cover pool is regulated by the Secondary Legislation by reference to assets referred to in a section of Act nr. 2588/20.8.2007 regarding the calculation of capital requirements in relation to credit risk according to the standardized approach. Following the entry into force of Regulation 575/2013 (Capital Requirements Regulation), this reference should be read as a reference to Article 129 of the Regulation. Cover assets are primarily residential mortgage loans, loans secured by a mortgage on commercial properties, loans secured by a mortgage on ships and loans to or guaranteed by state entities. Residential and commercial mortgage loans may only be included in the cover pool if the property subject to the mortgage is situated in Greece and hence is governed by Greek law. The loans may be secured by mortgage prenotations instead of full mortgages (as is the practice for cost reasons in Greece). In addition, exposures to credit institutions and investment services undertakings may be included in the cover pool up to an aggregate limit of 15% of the nominal value of the outstanding covered bonds. Derivatives may also be included in the cover pool to the extent that they are used exclusively for the purpose of hedging the interest rate, FX or liquidity risk. To the extent that the counterparties to such derivatives are credit institutions and investment services undertakings (as opposed to state entities or central counterparties in organized markets), the net present value of derivatives included in the pool is included in the above 15% limit. Finally, the cover assets may be substituted by certain tradable assets but only up to the amount by which the aggregate nominal value of the cover assets including accrued interest exceeds the nominal value of the outstanding covered bonds including accrued interest.

IV. VALUATION AND LTV CRITERIA

Loans secured by residential mortgages are required to have a loan to value (LTV) ratio of 80%, whereas loans secured by mortgages over commercial properties and ships are required to have an LTV ratio of 60%. Loans with a higher LTV ratio may be included in the cover pool, but they are taken into account for the calculation of the statutory tests described below only up to the amount indicated by the LTV ratio. Thus, by way of example, a loan of 900,000 Euros secured through a residential mortgage over a property valued at 1,000,000 Euros may be included in the cover pool but will be deemed for the purposes of the calculation of the statutory tests to be equal to 800,000 Euros.

The valuation of properties must be performed by an independent valuer at or below the market value and must be repeated every year in relation to commercial properties and every three years in relation to residential properties (Article 208 of Regulation 575/2013).

V. ASSET-LIABILITY MAMANGEMENT

The Secondary Legislation provides for tests that are required to be met for the full duration of the covered bonds.

More particularly, the Secondary Legislation provides for the following statutory tests:

(a) The nominal value of the covered bonds including accrued interest may not exceed at any point in time 95% of the nominal value of the cover assets including accrued interest.

(b) The net present value of obligations to holders of covered bonds and other creditors secured by the cover pool may not exceed the net present value of the cover assets including the derivatives used for hedging. This test must be met even under the hypothesis of a parallel movement of the yield curves by 200 basis points.

(c) The amount of interest payable to holders of covered bonds for the next 12 months must not exceed the amount of interest expected to be received from the cover assets over the same period. For the assessment of the fulfilment of this test derivatives entered into for hedging purposes are taken into account.

Tests (b) and (c) are performed on a quarterly basis. In case any of the tests is not met, the credit institution is obliged to immediately take the necessary measures to remedy the situation.

The results of the tests (a) to (c) above and the procedures used to monitor the compliance with such tests are audited on a yearly basis by an auditor independent of the statutory auditors of the credit institution.

The breach of the above mentioned legislation leads to regulatory sanctions. The parties can also agree that the breach of the statutory tests constitutes an event of default.

Moreover, since the Bank of Greece approves each issuance of covered bonds, it would not approve any issuance in case the statutory tests (including the liquidity test) are not met. Therefore a breach of the statutory (but not of any contractual) liquidity test would in practice lead to a Programme freeze. Also the failure to comply with the requirement to restore the statutory tests may lead to sanctions by the Bank of Greece. Apart from the sanctions provided by the Primary and the Secondary Legislation, the contracting parties may agree to additional sanctions, in particular, to alternative administration or an event of default.

VI. TRANSPARENCY

Currently, the issuer's reporting obligations (as described in detail under paragraph on reporting duties of section VII) and the disclosure of the cover pool as conducted via the summary registered with the competent land registry for the establishment statutory pledge (for more details on this issue we cross refer to paragraph on the cover pool monitor of section VII) are the basic transparency tools provided under applicable covered bonds legislation. So far in Greece no market or regulatory initiatives have been undertaken on the creation of a national transparency template, in line with the guidelines of the ECBC Label Initiative.

VII. COVER POOL MONITOR AND BANKING SUPERVISION

Cover pool monitor

The compliance with statutory tests, mentioned above, is audited by independent auditors. Such audit reports, as well as the quarterly compliance reports by the issuer shall be submitted with the Bank of Greece as regulator.

Prerequisites for the issuance of covered bonds

According to the Primary Legislation, covered bonds may be issued by credit institutions having Greece as home member state. However, in case of issuance of covered bonds by a credit institution having as home state another member state of the European Economic Area (EEA), and provided that they are characterized as covered bonds in accordance with the law of such member state, the provisions of the Primary Legislation on the creation of a statutory pledge will apply in relation to claims governed by Greek law, as well as the tax exemptions which apply to Greek bonds. Therefore, foreign banks established within the EEA having a significant loan portfolio in Greece may use the loans of such portfolio as part of the cover pool.

The Secondary Legislation sets additional prerequisites for the issuance of covered bonds. Specifically the credit institutions issuing covered bonds:

> must have certain minimum risk management and internal control requirements including suitable policies and procedures for the issuance of covered bonds, organizational requirements, IT infrastructure and a policy for the reduction and management of risks deriving from the issuance of covered bonds, such as interest rate risk, counterparty risk, operational risk, FX risk and liquidity risk; and

> must have aggregate regulatory capital of at least 500 million Euros and a capital adequacy ratio of at least 9%.

Reporting duties of the issuer to the supervisor concerning covered bonds and cover pool

Credit institutions that issue (directly or indirectly) covered bonds shall provide in their financial statements and on their websites information on such covered bonds including on the nominal value and net present value of the bonds and the cover pool and the net present value of derivatives used for hedging.

More particularly, pursuant the Secondary Legislation there are the following disclosure requirements to the Bank of Greece until the end of March of each year in relation to data as of end of December of the year preceding:

> The certified by auditor results arisen following the audit conducted pursuant to the provisions of the Secondary Legislation and following the follow-up of processes and restrictions as set by the Secondary legislation. Any detailed presentation of data, methods and parameters used should also be mentioned.

> Detailed data of the cover pool assets that would confirm the restrictions set under the Secondary Legislation along with the information related to the real estate's revaluation of the mortgages and other loans.

> The following data and information:

a) weighted average interest-rate per category of assets and weighted average interest-rate of all cover pool assets;

b) the real estate values of the mortgages and of the other loans;

c) validation of the selected policy of risk hedging with detailed analysis of the degree of effectiveness of this;

d) table of corresponding maturities of the covered bonds and corresponding assets of the cover pool and the derivatives;

e) Finally all the credit institutions have to communicate to the Bank of Greece, within 30 days from the expiry of each quarter, with data of 1st, 2nd and 3rd quarter end, concise information with regards to the results from the tests provided under the Secondary Legislation.

Banking supervision in crisis

As described in detail under section VIII of this article, the Primary Legislation provides that in case of insolvency of the issuer, the Bank of Greece may appoint an administrator, regardless of the powers they may assign to a special liquidator pursuant to the generally applicable banking special liquidation provisions, if the trustee does not do so.

VIII. SEGREGATION OF COVER ASSETS AND BANKRUPTCY REMOTENESS OF COVERED BONDS

Segregation of cover assets

In case of a direct issuance the cover assets are segregated from the remaining estate of the credit institution through a pledge constituted by operation of law (statutory pledge). In case of assets governed by a foreign law (which will typically include *inter alia* claims from derivative contracts) a security interest must be created in accordance with such foreign law. The statutory pledge and the foreign law security interest secure claims of the holders of covered bonds and may also secure (in accordance with the terms of the covered bonds) other claims connected with the issuance of the covered bonds, such as derivative contracts used for hedging purposes. The statutory pledge and any foreign law security interest is held by a trustee for the account of the secured parties.

The claims constituting cover assets are identified by being listed in a document signed by the issuer and the trustee. A summary of such document is registered in the land registry of the seat of the issuer. Such summary document includes within its content a description of the assets that constitute the cover pool. Claims may be substituted and additional ones may be added to the cover pool through the same procedure.

The Primary Legislation creates an absolute priority of holders of covered bonds and other secured parties over the cover pool. The statutory pledge supersedes the general privileges in favour of certain preferred claims (such as claims of employees, the Greek state and social security organizations) provided for by the Code of Civil Procedure. Furthermore, upon registration of the summary of the document listing the claims included in the cover pool, the issuance of the covered bonds, the establishment of the statutory pledge and the foreign law security interest and the entering into of all contracts connected with the issuance of the covered bonds are not affected by the commencement of any insolvency proceedings against the issuer.

In case of an indirect issuance or a direct issuance guaranteed by an SPE the cover pool assets are segregated from the estate of the credit institution by virtue of their sale to the special purpose entity. For such transfer, the provisions of the Bond Loan and Securitization Law apply, which provide equivalent protection from third party creditors and insolvency to the one the Primary Legislation provides in case of direct issuance.

It is worth noting that according to the Primary Legislation both in case of direct and of indirect issuance the cover assets may not be attached. This has the indirect result that the Greek law claims constituting cover assets are no longer subject to set-off, because according to Article 451 of the Greek Civil Code claims which are not subject to attachment are not subject to set-off. This is important because under generally applicable law borrowers the loans to whom become cover assets would have had a right to set-off, which would reduce the value of the cover pool, for all counterclaims (including notably deposits) predating the creation of the pledge or the transfer of the claims, as the case may be.

No specific provisions exist in relation to voluntary overcollateralisation. As a result the segregation applies to all assets of the cover pool, even if their value exceeds the minimum required by law. The remaining creditors of the credit institution will only have access to any remaining assets of the cover pool after the holders of the covered bonds and other creditors secured by the cover pool have been satisfied in full.

Bankruptcy remoteness of and impact of insolvency proceedings on covered bonds

According to the Secondary Legislation covered bonds do not automatically accelerate upon insolvency of the credit institution having issued (in a direct issuance structure) or guaranteed (in an indirect one) the covered bonds.

Pursuant to the Primary Legislation, as amended, the bond loan programme may provide that either from the outset or following the occurrence of certain events, as, indicatively, initiation of insolvency proceedings against the issuer, the trustee will be entitled to assign or undertake the collection and management, in general, of the cover assets by application *mutatis mutandis* of the Bond Loan and Securitization Law.

Additionally, the Primary Legislation provides that in case of insolvency of the issuer, the Bank of Greece may appoint an administrator, regardless of the powers they may assign to a supervisor or liquidator pursuant to Articles 137 and 145 of the Primary Legislation, if the trustee does not do so. The proceeds coming both from the collections of the claims that are included in the legal pledge and from the realization of the rest of the assets which are subject to the legal pledge are applied towards the repayment/redemption of the bonds and of the other claims, which are secured by the legal pledge, pursuant to the terms of the bond loan.

The provisions of the Bond Loan and Securitization Law are respectively applied in the sale, transfer, collection and administration, in general, of the assets comprising the cover.

In case of an indirect issuance the obligations of the credit institution under the Guarantee are automatically accelerated in case of bankruptcy by virtue of the generally applicable provisions of bankruptcy law, but this does not lead to automatic prepayment of the covered bonds. To the contrary, the terms of the covered bonds may provide that the proceeds of the Guarantee will be placed in a special account to be used for the servicing of the covered bonds.

Access to liquidity in case of insolvency

The Primary legislation provides that the trustee can be entitled, pursuant to the terms of the programme and the legal relationship connecting the trustee with the bondholders, to sell and transfer the cover assets, and to use the net proceeds of such sale in order to redeem the bonds which are secured by the legal pledge, by way of derogation from Articles 1239 and 1254 of the Civil Code.

The above-mentioned sale may occur by virtue of the Bond Loan and Securitization Law or the application of the general applicable provisions.

Exercise of the claims of covered bondholders against the remaining assets of the credit institution

The purpose of the Primary Legislation, as was expressly stated in the introductory note to the law, was to ensure that holders of covered bonds would have dual recourse both to the cover pool as secured creditors and to the remaining assets of the credit institution ranking as unsecured and unsubordinated creditors. This was also expressly stated in the Secondary Legislation.

The programme of the covered bonds may provide that more than one series or issues of bonds may be secured through a single statutory pledge.

The programme may also provide on any other issue related to the priority in satisfaction of the Covered Bondholders and the way they are organized in a group and they are represented, by derogation from the Bond Loan and Securitization Law. Furthermore, the parties may agree to apply a foreign law on these matters.

Protection of depositors

In order to not jeopardize the interests of depositors in case of insolvency of a credit institution due to the segregation (discussed above) of high quality assets in favour for the holders of covered bonds, the Secondary Legislation provides that, in case the cover assets exceed significantly the amount of 20% of the available assets of the credit institution on an unconsolidated basis, the Bank of Greece may impose additional capital adequacy requirements. For the purposes of this calculation available assets are considered to be all assets of the credit institution excluding (i) assets subject to securitization, (ii) assets subject to reverse repo agreements and (iii) assets encumbered in favour of third parties. In exercising its discretion to impose additional capital adequacy requirements the Bank of Greece will take into account qualitative considerations such as (i) any deterioration of the average quality of the remaining available assets after the issuance of covered bonds, (ii) the increase of the liquidity of the credit institution combined and any positive effects it may have on its credit rating and prospects and (iii) the results of additional stress tests. As of November 2014 the authority to impose additional capital requirements was conferred to the European Central Bank subject to and in accordance with the provisions of Regulation 1024/2013.

After the entry into force of Regulation 575/2013 it should be deemed that provisions of national law on capital requirements have been tacitly abolished. This would apply to the above provision of the Secondary Legislation. The purpose of protecting depositors from an excessive encumbrance of assets is served indirectly by Article 45 of Directive 2014/59 (the Banking Recovery and Resolution Directive or BRRD)[1], which provides for a minimum requirement of own funds and eligible liabilities, as covered bonds and other secured liabilities are not eligible according to this provision.

IX. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

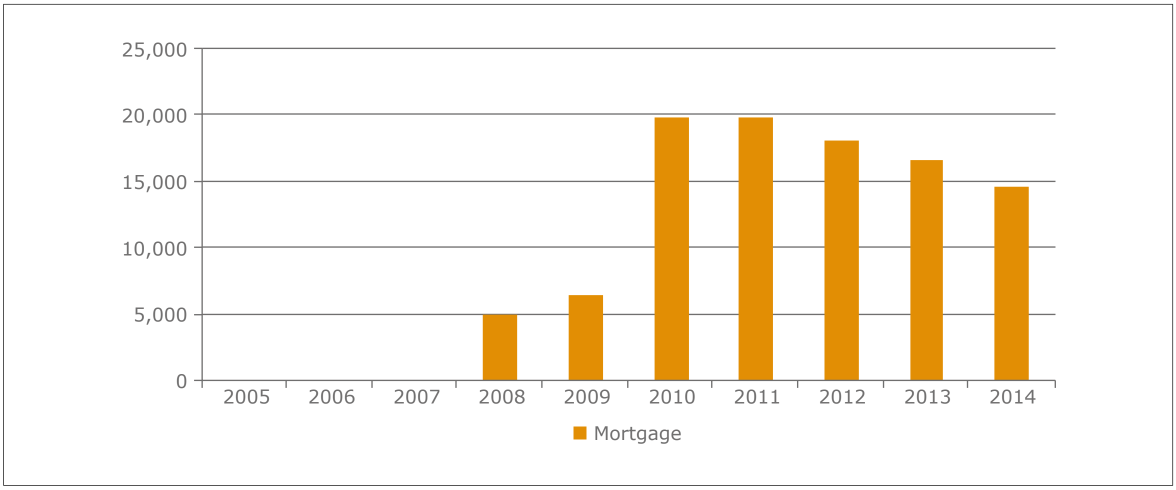
The risk-weighting of covered bonds (both Greek and foreign) is regulated by Article 129 of Regulation 575/2013. According to this bonds falling within the provisions of Article 52(4) of the UCITS Directive are eligible for preferential treatment, provided that the cover pool consists of the assets enumerated in paragraph 1 of Article 129 of Regulation 575/2013 and the provisions of paragraph 7 of the same article regarding the information provided to holders of covered bonds are met. By way of exception, bonds issued before the 31st December 2007 and falling within the provisions of Article 52(4) of the UCITS Directive are considered as covered bonds, even if the cover assets do not comply with the provisions of Regulation 575/2013[2].

Directly issued Greek covered bonds comply with both the UCITS Directive and Regulation 575/2013 and, therefore, have the reduced risk-weighting mentioned above in Greece and should also have it in other EU member states. In relation to indirectly issued covered bonds it must be noted that they do not fall within Article 52(4) of the UCITS Directive, because they are not issued by a credit institution.

[1] As of 30 April 2015 Greece had not transposed the BRRD.

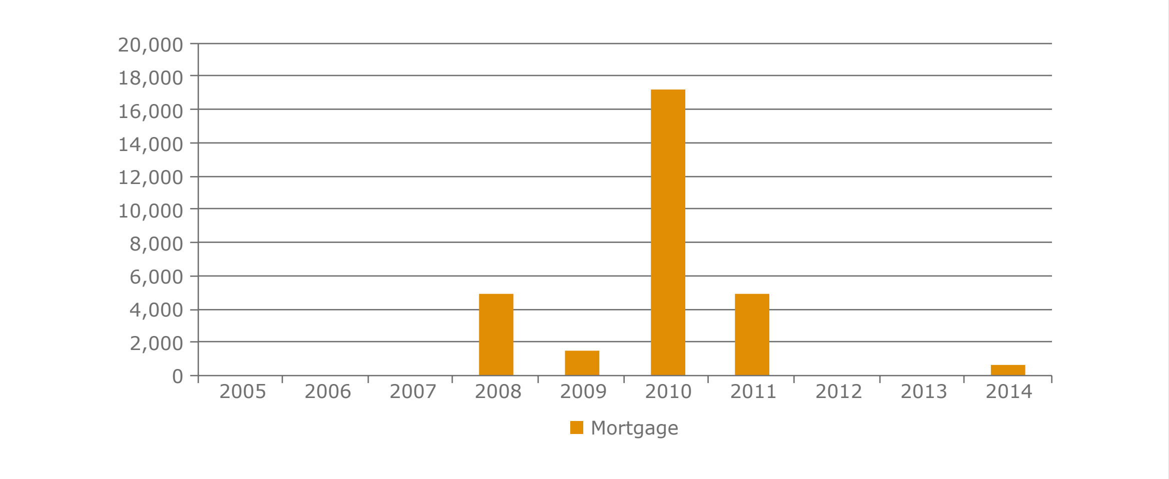
[2] Please click on the following link for further information on the UCITS Directive and the Capital Requirements Regulation (CRR): http://ecbc.hypo.org/Content/default.asp?PageID=504#position.

> Figure 1: Covered Bonds Outstanding, 2005-2014, EUR m



Source: EMF-ECBC

> Figure 2: Covered Bonds Issuance, 2005-2014, EUR m



Source: EMF-ECBC

Issuers: There are four issuers in Greece: Alpha Bank;National Bank of Greece; Eurobank Ergasias and Pireus Bank.

ECBC Covered Bond Comparative Database: http://ecbc.eu/framework/66/Greece.

3.14 HUNGARY

By András Gábor Botos, Association of Hungarian Mortgage Banks

I. FRAMEWORK

Act No. XXX of 1997 on Mortgage Banks and Mortgage Bonds (Mortgage Bank Act) contains the specific rules applicable to mortgage banks and mortgage bonds. Act No. CCXXXVII of 2013 on Credit Institutions and Financial Enterprises is applicable generally to the establishment, operation, supervision and liquidation of mortgage banks, unless otherwise provided by the Mortgage Bank Act.

II. STRUCTURE OF THE ISSUER

Mortgage banks are specialised credit institutions in Hungary whose business activity is restricted, in principle, to mortgage lending and auxiliary financial services: mortgage banks grant financial loans secured by mortgages on real estate property located on the territory of the Republic of Hungary and other European Economic Area (EEA) countries. Funds will be raised by way of issuing mortgage bonds. In the Hungarian banking sector only mortgage banks are entitled to issue mortgage bonds ("*jelzáloglevél*"). Cover assets will be held on the balance sheet of the mortgage bank. All the mortgage bonds of a single mortgage bank are covered by the same coverage pool which is only open to changes with the prior permission of the coverage supervisor, acting in the interest of mortgage bond holders.

III. COVER ASSETS

The Mortgage Bank Act provides that mortgage banks shall always possess cover surpassing the principal of outstanding mortgage bonds and the interest thereon both on a nominal basis and based on present value calculation. Decree No. 40/2005. (XII.9.) of the Minister of Finance contains the detailed provisions on the present value calculation of cover assets and the methodology of stress tests to be published on a regular basis. Furthermore, mortgage banks shall prepare a manual of keeping the register of cover assets ("*fedezet-nyilvántartás*"), which also needs the approval of the Hungarian National Bank (HNB) in its capacity as financial supervisory authority and the coverage supervisor.

Loans secured by a residential real estate can be taken in cover up to 70% of the mortgage lending value of the property. In case of loans secured by commercial real estate the limit is 60%.

Mortgage bonds are covered by loans secured by mortgages ("*jelzálogjog*"), independent mortgage liens ("*önálló zálogjog*"), separated mortgages ("*különvált zálogjog*") or by joint and several surety assumed by the Hungarian State ("*állami készfizető kezességvállalás*"). Supplementary coverage may exclusively consist of liquid assets listed in the Mortgage Bank Act and may not exceed 20% of the coverage. Pursuant to the Mortgage Bank Act, cover assets must be entered into the register of cover. The availability and quality of cover assets is permanently monitored by the coverage supervisor, reports on availability and quality of cover assets are disclosed on a daily basis.

According to Section 14 (5) of the Mortgage Bank Act, in the case when mortgage bonds and their coverage are not denominated in the same currency, the mortgage bank is obligated to hedge the currency exchange risk by entering into derivative transactions. Section 3 (10) of the Mortgage Bank Act provides that mortgage banks are entitled to conclude such transactions exclusively for hedging purposes, i.e. risk management and liquidity. The Mortgage Bank Act entitles mortgage banks to include derivatives in the ordinary coverage as well.

IV. VALUATION AND LTV CRITERIA

The rules of calculation of the mortgage lending value ("*hitelbiztosítéki érték*") are included in the Decree of the Minister of Finance No. 25/1997 on the Calculation Methods of the Mortgage Lending Value of Real Estate not Qualifying as Agricultural Land and the Decree of the Minister of Agriculture No. 54/1997 on the Calculation

Methods of the Mortgage Lending Value of Real Estate Qualifying as Agricultural Land. Both decrees prescribe the use of comparative methods, and prescribe the application of the principle of carefulness in the valuation process. Furthermore, they also determine the validity of the valuation report.

Mortgage banks may also provide appraisal services to determine the market value and the mortgage lending value of real properties.

Mortgage lending value calculation provisions refer to the sustainable aspects of the property. The mortgage bank's internal regulation for determining mortgage lending value is based on methodological principles defined in the above decrees. Such internal regulations are also subject to the former approval of the HNB.

V. ASSET – LIABILITY MANAGEMENT

As indicated above, the Mortgage Bank Act provides that mortgage banks shall always possess cover surpassing the principal of outstanding mortgage bonds and the interest thereon. Mortgage banks shall comply with the above requirements as follows:

> The aggregate amount of the outstanding principal claims considered as coverage, reduced by the amount of any value adjustments, shall exceed 100% of the amount of the nominal value of the outstanding mortgage bonds; and

> The aggregate amount of interest accrued on the outstanding principal claims considered as coverage, reduced by the amount of any value adjustments, shall exceed 100% of the amount of interest accrued on the nominal value of the outstanding mortgage bonds (Section 14 (2) of the Mortgage Bank Act).

Under Section 14 (4) of the Mortgage Bank Act the amount of coverage for mortgage bonds shall always be calculated and published at their present value as well.

Cash flow mismatch between cover assets and cover bonds is furthermore reduced by special prepayment restrictions on the borrowers' side.

VI. TRANSPARENCY

Mortgage banks shall publish the amount of the nominal value and the accrued interest of the outstanding mortgage bonds as well as the value of the coverage assets in a national daily newspaper and in the Exchange Journal as of the last day of each quarter, before the last day of the next month. Such figures need to be certified by the coverage supervisor and disclosed to the HNB as well.

VII. COVER POOL MONITOR AND BANKING SUPERVISION

The coverage supervisor (cover pool monitor) shall be appointed by the mortgage bank and approved by HNB. According to Section 16 of the Mortgage Bank Act, a company auditor or an auditor may be appointed; however, the coverage supervisor may not be identical with the auditor of the mortgage bank.

As a matter of fact, Hungarian mortgage banks have had one of the "big four" audit companies as coverage supervisor from the beginning of their operations. The coverage supervisor is responsible for monitoring and certifying, on a permanent basis:

> the existence of eligible security; and

> the registration of the eligible security in the coverage register. In accordance with Section 11 (2) (n) of the Mortgage Bank Act, a certificate from the coverage supervisor shall be attached to each mortgage bond regarding the existence of the coverage.

AAccording to section 16 (7) of the Mortgage Bank Act, a coverage supervisor may be appointed for a fixed period of time, not exceeding five years, however, he may be re-appointed following the termination of the period of his appointment. Although the contract of appointment concluded between the mortgage bank and the coverage supervisor is governed by civil law, it may not be lawfully terminated without the approval of the HNB. Within the scope of his coverage supervision activities, the coverage supervisor may not be instructed by the mortgage bank.

The HNB is responsible for verifying the compliance of the credit institutions, including the mortgage banks, with the Credit Institutions Act and other acts e.g. the Mortgage Banks Act, and applicable banking regulations. The HNB is entitled to impose various sanctions on credit institutions, including warnings of non-compliance, withdrawing licences and imposing fines on credit institutions and their management. Section 22 and 23 of the Mortgage Bank Act provides that the Hungarian Financial Supervisory Authority shall exercise special supervision over mortgage banks in addition to the provisions of the Credit Institutions Act and the provisions of the Capital Markets Act. Within the framework of such special supervision, HNB shall draw up an analysis schedule and conduct on site audits of mortgage banks according to the analysis schedule it compiles.

VIII. SEGREGATION OF COVER ASSETS AND BANKRUPTCY REMOTENESS OF COVERED BONDS

Pursuant to the Mortgage Bank Act a cover pool administrator will be delegated to the insolvent mortgage bank to safeguard the interests of bondholders and derivative partners. The cover pool administrator cannot be identical with the insolvency administrator of the mortgage bank. The cover pool administrator should provide for the timely satisfaction of principal and interest claims of bondholders and derivative partners in case of a possible insolvency situation. The cover pool administrator will only safeguard the interests of bondholders and derivative partners and will also have an access to the part of assets not qualifying as coverage and those not recorded in the cover register. The transfer of the portfolio or parts of it to another mortgage bank may grant for liquidity, however, the transfer of the portfolio or parts of it requires the prior written consent of the HNB.

As a general rule, Section 20/A (4) of the Mortgage Bank Act declares that the cover pool administrator is obliged to maintain the liquidity of the pool on a constant basis, allowing transfer of the pool or parts of it to another mortgage bank and to enter into derivative transactions. Within two years after the commencement of the liquidation procedure, both the cover pool administrator and the bondholders may request the court to complete the cover from the general insolvency estate. The cover pool administrator shall be entitled to receive remuneration for his work and refund of appropriate expenses. Although holders of the mortgage bonds, derivative partners or the coverage supervisor may inform HNB or the only competent Metropolitan Court Budapest on issuer default, after proving all relevant circumstances, it is only the HNB who is entitled to initiate an insolvency proceeding against the mortgage bank.

Hungarian legal provisions also provide for a wide-range of measurements, including extraordinary measurements, to be taken by the HNB prior to any insolvency situation.

For example, the HNB is entitled to delegate a supervisory commissioner to the mortgage bank. This extraordinary measurement may be taken by the HNB prior to the commencement of any insolvency procedure – in accordance with Section 157 (1) of the Credit Institution Act. In this case both the rights of the owners of the mortgage bank and the rights of the management of the mortgage bank will be restricted in order to guarantee the satisfaction of the claims of the mortgage bank's creditors, e. g. bondholders' and derivative partners' claims.

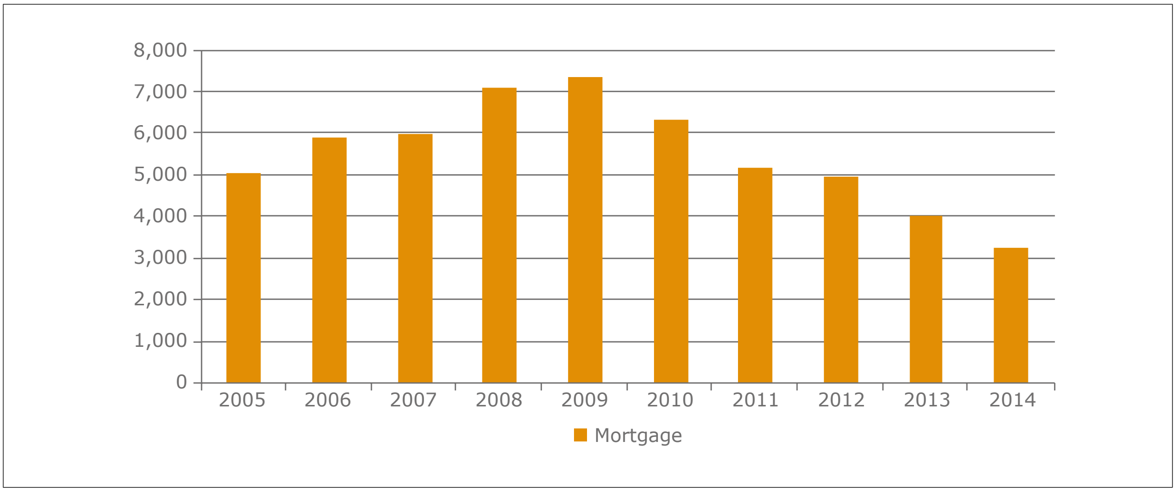
IX. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

The legislation when taken together with the practices, processes and procedures across the industry should fall within the criteria of Article 129 of the Capital Requirements Regulation (CRR). Hungarian mortgage bonds comply with the requirements of Article 52(4) UCITS as well as with those of Article 129(1) CRR.[1]

Hungarian covered bonds issued in euro zone countries qualify as European Central Bank (ECB) eligible. Furthermore, already in February 2008 one of the Hungarian mortgage banks successfully closed its debut transaction in the "Jumbo" covered bond market.

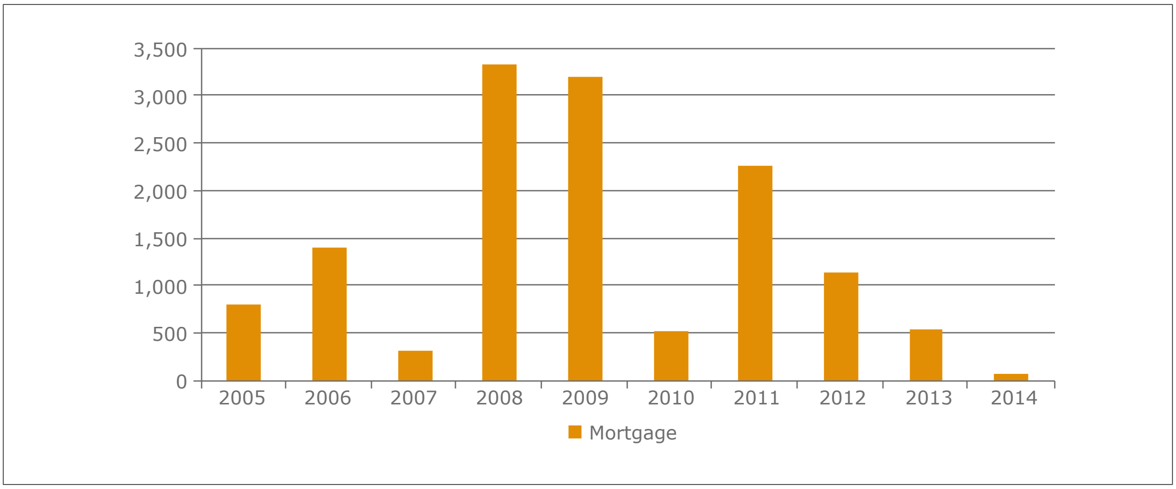
[1] Please click on the following link for further information on the UCITS Directive and the Capital Requirements Regulation (CRR): http://ecbc.hypo.org/Content/default.asp?PageID=504#position.

> Figure 1: Covered Bonds Outstanding, 2005-2014, EUR m



Source: EMF-ECBC

> Figure 2: Covered Bonds Issuance, 2005-2014, EUR m



Source: EMF-ECBC

Issuers: OTP Jelzálogbank Zrt. (OTP Mortgage Bank Ltd.), FHB Jelzálogbank Nyrt. (FHB Mortgage Bank Ltd.) and UniCredit Jelzálogbank Zrt. (UniCredit Mortgage Bank Ltd).

ECBC Covered Bond Comparative Database: http://ecbc.eu/framework/27/Hungarian_Covered_Bonds.

3.15 ICELAND

By Eiríkur Magnús Jensson and Kristín Erla Jónsdóttir, Arion Bank

I. FRAMEWORK

In Iceland, the issuance of covered bonds is governed by the Icelandic Covered Bond Act, which came into force on 14 March 2008 (Lög nr. 11/2008 um sértryggð skuldabréf, hereinafter the "ICBA"). The ICBA supersedes the general bankruptcy law and grants covered bond investors a priority claim on eligible cover assets (ICBA: Chapter VII, Article 14). Regulatory provisions no. 528/2008 (Reglur nr. 528/2008, hereinafter the "ICBR") established by the Icelandic Financial Supervisory Authority (Fjármálaeftirlitið, hereinafter the "FME") complement the legislation. These regulations define in more detail the criteria for obtaining a covered bond issuance licence, the universe of eligible cover assets, valuation procedures for eligible cover assets, asset and liability management, and the form and maintenance of the cover register.

II. STRUCTURE OF THE ISSUER

The FME grants licences for the issuance of covered bonds. Licences to issue covered bonds can only be granted to commercial banks, savings banks and credit undertakings. The issuer must meet certain criteria to qualify for the license. These criteria include the submission of a financial plan, confirmed by a public accountant, proving the issuer's financial stability for at least the next three years; a description of the proposed covered bond issuance and how the issuer intends to organise and administrate the covered bond issuance; and the covered bond register as well as written confirmation from the issuer that he and the planned bond issue comply with the ICBA and ICBR. The FME has the right to withdraw the licence should the issuer be in material breach of the ICBA or if the issuer has failed to issue covered bonds within one year of receiving the licence (Figure 1).

> Figure 1: Licence needed to issue covered bonds

Requirements for issuance licence

- Issuer must supply the FME with a board resolution that the board approves the application for a covered bond licence.
- Description of the proposed bond issuance and how the issuer intends to keep and organise the covered bond register.
- Information about the covered bond register, e.g. how the issuer will maintain the register as well as how the register will be supervised.
- The FME can allow an issuer to convert previously issued bonds used to finance assets that are eligible under ICBA into covered bonds.
- The issuer must submit a financial plan, confirmed by a public accountant, proving the issuer's financial stability for at least the next three years; a description of the proposed covered bond issuance and how the issuer intends to organise and administrate the covered bond issuance; and the covered bond register as well as written confirmation from the issuer that he and the planned bond issue comply with the ICBA and ICBR.
- The issuer must submit information about IT systems used in relation to the covered bond issuance.
- The issuer must submit any other information that is relevant for the proposed bond issuance.
- A written statement from the issuer that it and the issue fulfil the requirements made by the ICBA and the ICBR.

The cover assets represent a claim of the covered bond issuer and remain on the balance sheet. There is no subsequent transfer of cover assets to another legal entity. The covered bonds are direct, unconditional obligations on the part of the issuer. Outstanding covered bonds are backed in their entirety by the cover pool. Hence, there is no direct legal link between a single cover asset and a particular covered bond series. In the event of issuer insolvency, the cover pool is bankruptcy remote from the general insolvency estate of the issuer and exclusively available to meet outstanding claims of covered bond investors. It should also be noted that covered bond investors enjoy recourse to the insolvency estate of the issuer, ranking pari passu with senior unsecured investors.

III. COVER ASSETS

Eligible assets in the covered bond register are mortgage loans and public sector assets (ICBA Chapter II, Article 5). The ICBA does not specify separate cover pools for mortgage and public sector cover assets. Both asset classes can be mixed in one cover pool. Icelandic covered bond issuers have issued covered bonds where the asset register consists exclusively of residential mortgages.

Eligible assets according to ICBA are:

> Mortgages secured by residential housing in member states[1];

> Mortgages secured by industrial, office or commercial property in member states;

> Mortgages secured by farms and other real estate used for agricultural purposes in member states; and

> Public sector assets defined as bonds issued by the Icelandic state or other member state, municipality in Iceland or in another member state, or guaranteed by such member state.

Derivative contracts

The ICBA provides for the use of derivatives for hedging interest and currency risk. The derivatives must be structured such that premature termination is not triggered by an issuer default or a demand by the counterparty. Derivative counterparties must have a rating from rating agency approved by the FME. The minimum is a long-term rating of A3/A-/A- (Moody's/S&P/Fitch) or short-term rating of P2/A2/F2. If the counterparty's rating falls below the minimum level, the issuer of covered bond can:

> Request additional collateral;

> Terminate the derivative contract and open a new contract with a counterparty that meets the minimum rating requirement, or;

> Request that the counterparty provide a guarantee from a third party that meets the minimum rating requirement.

Substitute assets

The ICBA allows for the inclusion of the following substitute assets:

> Demand deposits with a regulated financial firm;

> Deposits with or claims against a member state or central bank in a member state;

> Claims against other legal entities which, in FME's estimation, do not involve greater risk than those referred to in the two points above of this paragraph.

[1] Member state: a state which is a party to the Agreement on the European Economic Area or the European Free Trade Association Treaty, or the Faroe Islands.

FME may approve as substitute collateral the following claims:

> Claims against municipalities in member states;

> Claims against a regulated financial firm other than those referred to the point above (of the first paragraph), provided the final maturity is within one year of their issuance;

> Claims against foreign development banks listed in rules adopted by FME;

> Claims against other legal entities which do not involve greater risk than the substitute collateral referred to the three points above of this paragraph.

Substitute collateral may not comprise more than 20% of the value of the cover pool. The FME may authorise an increase in the proportion of substitute collateral in the cover pool to as much as 30% of its value.

IV. VALUATION AND LTV CRITERIA

The ICBA defines valuation principles for properties that act as a collateral for mortgages in the cover pool (ICBA: Chapter III, Article 7). An assessment of the market value of real estate shall be based on the selling price in recent transactions with comparable properties. If the market value of real estate is not available, it shall be determined by a specific valuation. The valuation shall be based on generally accepted principles for market valuation of real estate. Data on real estate price developments from the Land Registry of Iceland of Iceland, for instance, may be used as a basis, together with other systematic collection of real estate price data.

If an issuer assesses the market value of real estate, the independent inspector provided for must verify that the appraisal is based on accepted methodology. The inspector may re-assess the market price of one or more properties if he/she regards the valuation as incorrect.

An appraisal of the market value of real estate must be in writing and must specify what methodology is used, who has carried out the appraisal and when it was made.

For the various mortgage types eligible as cover, the maximum LTV ratios apply (ICBA: Chapter III, Article 7):

> 80% of the value for real estate, side-leasehold rights and tenant-owner rights where the property is intended for residential use.

> 70% of the value for real estate intended for agricultural use.

> 60% of the value for real estate, site-leasehold rights and tenant-owner rights where the property is intended for office or commercial use.

V. ASSET – LIABILITY MANAGEMENT

The ICBA requires that the nominal value of the cover assets at all times exceed the aggregate nominal value of claims arising from outstanding covered bonds against the issuer (ICBA: Chapter V, Article 11). In addition, the law requires that on a net present value (NPV) basis, cover assets, including derivatives, always exceed the corresponding value of the interest and principal of outstanding covered bonds, taking into account the effects of stress-test scenarios on interest and currency risk set by the FME. The FME defines the stress test for interest-rate risk as a sudden and sustained parallel shift in the reference curve by 100bps up and down. The reference curve is based on Icelandic government bonds for covered bonds in Icelandic krona but swap rate curves for other currencies. Likewise, it defines currency risk as a 10% sudden and sustained change in the relevant foreign exchange rate between the currency of covered bonds and the currency of cover assets (ICBR: Chapter 4, Article 8). The ICBA does not require a mandatory level of minimum overcollateralization (OC). However, the issuer can adhere the to a self-imposed OC level for structural enhancement, as the ICBA protects any OC in the cover pool in the event of issuer insolvency.

Finally, the issuing institution shall ensure that the cash flow with respect to the assets in the cover pool, derivatives agreements and the covered bonds are such that the institution is always able to meet its payment obligations towards holders of covered bonds and counterparties in derivatives agreements (ICBA: Chapter V, Article 11). The issuer should be able to account for these funds separately

VI. TRANSPARENCY

The issuers are already presenting information regarding their cover pool and outstanding covered bonds on a monthly or at least on quarterly basis. This information is today on the issuer's website.

VII. COVER POOL MONITOR AND BANKING SUPERVISION

The covered bond issuers fall under the special supervision of the FME. The financial regulator monitors the institutions' compliance with the ICBA and other related regulatory provisions (e.g. ICBR). If the covered bond issuer is in material breach of its obligation under the legal framework, the FME can issue a warning or revoke the issue license altogether. The FME may also revoke a license if the institution has declared that it waives the license or if the institution has not made use of the license within a year from the date of receiving the license. The revocation may be combined with an injunction against continuing the operations and with the imposition of a conditional fine. In any case, the FME must determine how the operations should be wound up (ICBA: Chapter IX, Articles 24–29).

For each issuing institution, the FME must appoint an independent and suitably qualified cover pool inspector, who is paid by the covered bond issuer. The duties of the cover pool inspector are to monitor the register and verify that covered bonds, derivatives agreements and the cover assets are correctly recorded. The inspector also ensures compliance with matching and market risk limits in accordance with ICBA. The institution is obliged to provide the covered bond inspector with any information requested relating to its covered bond operations. The cover pool monitor must submit a report of the inspection to the FME on an annual basis and must notify the FME as soon as he/she learns about an event deemed to be significant to the supervisory authority (ICBA: Chapter VII, Articles 21–23).

VIII. SEGREGATION OF COVER ASSETS AND BANKRUPTCY REMOTENESS OF COVERED BONDS

Cover register

The issuer must keep a register of eligible cover assets, substitute assets, derivative contracts and outstanding covered bonds (ICBA: Chapter 6, Section 13). The law specifies the form and content of such a register, which must be easily accessible to the FME and the cover pool inspector. The registration legally secures covered bond holders and derivatives counterparties a priority claim on the cover pool in the event of issuer insolvency (ICBA: Chapter 7, Section 14). Prior to an issuer being declared insolvent, cash flows accruing from the cover assets must be accounted for separately by the issuer. In the event of issuer default, covered bond investors and derivative counterparties have the same priority claim on these funds as they have on the cover pool. Moreover, cash flow accruing from the cover assets after issuer insolvency must be registered in the cover pool.

Issuer insolvency

In the event of issuer insolvency, the registered cover assets and the respective covered bonds are segregated from the general insolvency estate. An issuer default does not trigger the premature termination of registered derivative contracts. Covered bond holders and registered derivative counterparties have a priority claim on the cover pool and cash that derives from the pool, ensuring timely repayment to original agreed terms, as long as the pool complies with the ICBA. However, the cover pool does not constitute a separate legal estate.

Cover pool insolvency and preferential treatment

In the event that the cover pool breaches eligibility criteria, covered bonds are accelerated. Covered bond investors and derivative counterparties would have priority claim on the proceeds from the sale of the cover assets, ranking pari passu among themselves. If the proceeds are insufficient to repay all liabilities on outstanding covered bonds, covered bond investors and derivative counterparties have an ultimate recourse to the insolvency estate of the issuer, ranking pari passu with senior unsecured investors.

Survival of OC

Any overcollateralization (OC) present in the cover pool at the time of issuer insolvency is bankruptcy-remote provided it is identified in the cover pool register. Indeed, the CBIA requires full repayment of outstanding claims on covered bonds and registered derivatives before cover assets are available to satisfy claims on unsecured creditors. The law does not provide for the appointment of a special cover pool administrator. The receiver-in-bankruptcy represents the interest of both the covered bond investors and the unsecured investors. The receiver has the right to use OC to pay advance dividends to other creditors of the bankrupt issuer if the pool contains more assets than necessary. If the cover pool assets later prove to be insufficient, these advance dividend payments can be reclaimed.

IX. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

The legislation when taken together with the practices, processes and procedures across the industry should fall within the criteria of Article 129 of the Capital Requirements Regulation (CRR). Icelandic covered bonds comply with the criteria of Article 52(4) UCITS and with the covered bond criteria defined in Article 129(1) CRR.[2] The ICBA explicitly lists mortgages against property for agricultural purposes and mortgages against the pledging of tenant-owner rights as eligible cover assets, while the CRR does not. In addition, issuers can impose self-restrictions to ensure that their covered bond issues comply with the CRR. Icelandic covered bonds are not eligible for repo transaction with the Sedlabanki (the Icelandic Central Bank).

X. ADDITIONAL INFORMATION

Legislative covered bonds in Iceland

Arion Bank and Íslandsbanki were both granted a licence to issue covered bonds under ICBA in the fall of 2011 and both followed up by issuing covered bonds denominated in Icelandic krona to domestic investors. Landsbankinn was granted a licence to issue covered bonds in April 2013 and issued their first covered bonds in June 2013. The banks use their covered bond programs to fund their residential mortgage portfolios.

A specific attribute of the Icelandic mortgage market is that the largest majority of Icelandic mortgages are inflation linked. This means that the principal of each mortgage follows the changes in consumer prices in Iceland. This has changed since 2011 when the banks started to offer fixed rate loans that were not tied to inflation. Normally, the bonds are registered at the Nasdaq OMX Iceland (NASDAQ OMX Group) or another European stock exchange.

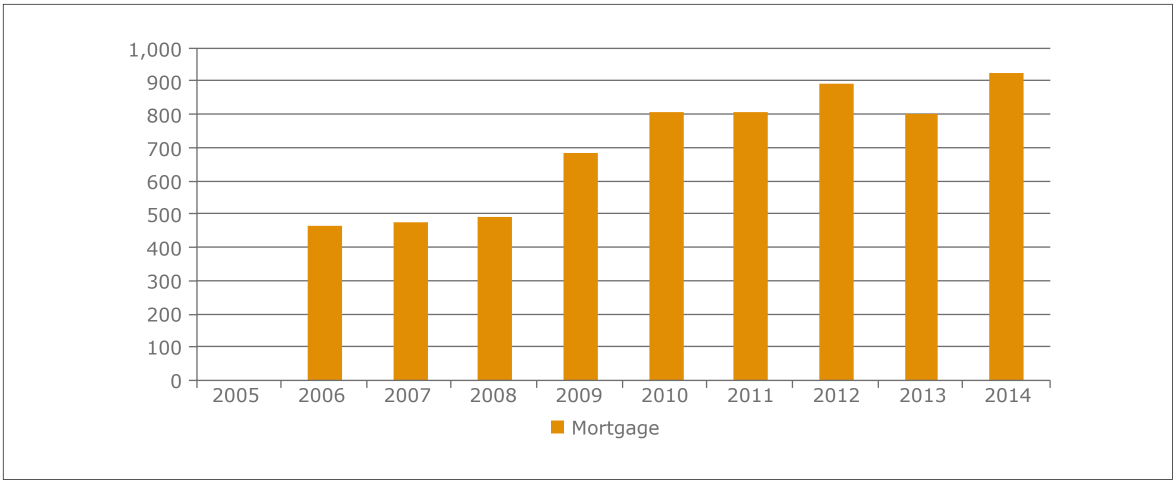
Covered bonds in Iceland prior to the financial crisis of 2008

The legislation on covered bonds (ICBA) came into force in March 2008 only a few months before the collapse of the Icelandic financial system in October month of the same year. Covered bonds based on the legislation had not been issued prior to the crisis of 2008 although one bank had been granted a licence from the FME to issue covered bonds without ever issuing bonds.

Both Glitnir and Kaupthing bank and other smaller financial institutions set up structured covered bond programs in 2006 and 2007. The bonds issued of these programs were mainly used as collateral in repo transactions with the Central bank of Iceland and/or other counterparties. A small minority of these bonds was sold to other investors. The holders of the structured covered bonds did not take a loss on their holding despite the bankruptcy proceedings of the issuers. The largest of these structured covered bond programs was the Kaupthing ISK 200 bn covered bond program that was restructured in late 2011 when Arion bank took over as issuer and acquired the mortgages under the program. Total outstanding Arion Bank structured covered bonds is EUR 489 million as of 31 December 2014.

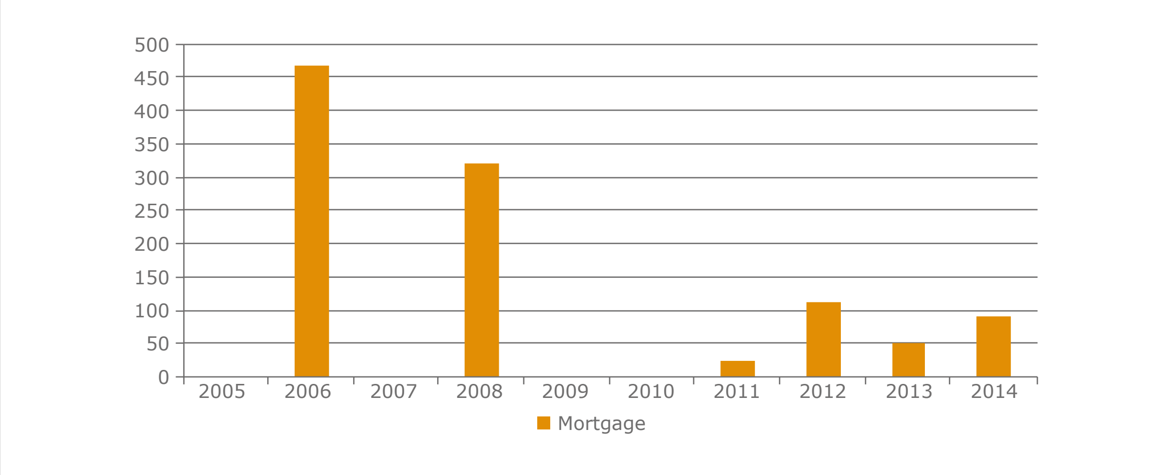
[2] Please click on the following link for further information on the UCITS Directive and the Capital Requirements Regulation (CRR): http://ecbc.hypo.org/Content/default.asp?PageID=504#position.

> FIGURE 2: COVERED BONDS OUTSTANDING, 2005-2014, EUR M



Source: EMF-ECBC

> FIGURE 3: COVERED BONDS ISSUANCE, 2005-2014, EUR M



Source: EMF-ECBC

Issuers: There are currently three issuers in Iceland – Arion Bank, Íslandsbanki and Landsbankinn.

ECBC Covered Bond Comparative Database: http://www.ecbc.eu/framework/108/Icelandic_Covered_Bonds.

3.16 IRELAND

By Nick Pheifer, DEPFA BANK and Sinéad Gormley, Bank of Ireland

I. FRAMEWORK

Irish covered bonds benefit from the protection of specialist covered bond legislation in the Irish Asset Covered Securities Acts 2001 and 2007 (the "ACS Acts") and the regulations and regulatory notices issued thereunder. The framework provides for the issuance of asset covered securities ("ACS") secured on public credits, mortgage credits (each, as defined below) and commercial mortgage credits (being obligations secured on commercial property assets). There is currently no issuer of ACS secured on commercial mortgage credits in the Irish market and consequently this chapter focuses on the framework applicable to ACS secured on public credits and mortgage credits.

II. STRUCTURE OF THE ISSUER

An issuer of ACS (an "ACS Issuer") must hold a banking licence and be registered under the ACS Acts as a designated credit institution. It is required to limit the scope of its banking activities to certain permitted business activities. An ACS Issuer is therefore subject to regulation by the Central Bank of Ireland (the "CBI") in its capacity as a bank and separately, in its capacity as an ACS Issuer. Each ACS Issuer will be registered as a designated public credit institution (authorised to issue public credit covered securities) and/or a designated mortgage credit institution (authorised to issue mortgage credit covered securities).

The ACS Issuer holds the assets backing the ACS on its balance sheet. The collection of either mortgage credit assets or public credit assets (the "cover assets") backing the issue of ACS (the "cover pool") is described as dynamic or open in the sense that the ACS Issuer may move cover assets in and out of the cover pool provided that it does so in accordance with the provisions of the ACS Acts. One such control is that the ACS Issuer must maintain a register (a "cover register") of all ACS issued, all cover assets hedge contracts and the cover assets (including any substitution assets and any cover assets constituting over-collateralisation) and any amendment to the cover register can only be effected with the approval of a cover-assets monitor (the "CAM") which is an independent professional third party, or the CBI (see further section VII below).

Statutory preference

The claims of ACS holders are protected by a statutory preference under the ACS Acts. As preferred creditors, upon an ACS Issuer insolvency, ACS holders are entitled to have recourse to the cover assets included in the cover pool ahead of all other creditors of the ACS Issuer other than the super-preferred creditors (i.e. the CAM and NTMA – see further section VIII below) and pari passu with other preferred creditors (such as the pool hedge counterparties – see further section V below). In this way the ACS holders have protection against the general Irish insolvency laws.

Restriction on business activities

The ACS Acts provide that an ACS Issuer may not carry on a business activity other than a permitted business activity as set out in the ACS Acts. Permitted business activities comprise dealing in and holding public credit assets or mortgage credit assets (depending on the type of designation of ACS Issuer) and limited classes of other assets, engaging in activities connected with the financing and refinancing of such assets, entering into certain hedging contracts, holding collateral under cover assets hedge contracts (referred to in the ACS Acts as "pool hedge collateral") and engaging in other activities which are incidental or ancillary to these activities. The ACS Acts limit the scope of non-core ACS business that an ACS Issuer can undertake by restricting its dealing in or holding of financial assets that are not otherwise eligible for inclusion in the cover pool to 10% of the total of all the ACS Issuer's assets. There is also a similar 10% limit imposed on the volume of non-cover pool-eligible OECD assets that an ACS Issuer can acquire. In addition, designated mortgage credit institutions must maintain the aggregate prudent loan to value ("LTV") of their overall mortgage books at or below 100%.

III. COVER ASSETS

The classes of assets which are eligible for inclusion in a cover pool are determined by whether the ACS Issuer is a designated public credit institution or a designated mortgage credit institution.

Designated public credit institutions

The classes of asset eligible for inclusion in the cover pool of a designated public credit institution ("public credit assets") are financial obligations (collectively, "public credits"), including obligations given as a guarantor or surety and indirect or contingent obligations, in respect of money borrowed or raised (whether in the form of a security that represents other public credit that is securitised or not) where the obligor is any one of the following:

> central governments, central banks (each, a "Sovereign"), public sector entities, regional governments or local authorities (each, a "Sub-sovereign") in any EEA country;

> Sovereigns in Australia, Canada, Japan, New Zealand, the Swiss Confederation or the USA (each, an "Eligible Non-EEA Country");

> Sub-sovereigns in any Eligible Non-EEA Country; and

> Multilateral development banks or international organisations, in each case which qualify as such for the purposes of the Capital Requirements Regulation ("CRR").

Risk-weighting and credit worthiness tests apply to the categories of cover assets outside the EEA countries to comply with the CRR covered bond eligibility requirements. Sovereign obligations from an Eligible Non-EEA Country must have an independent credit rating of at least step 1. Sub-sovereign obligations from an Eligible Non-EEA Country must have an independent credit rating of at least step 1 and a risk-weighting at least equal to that of an institution, central government or central bank. Sovereign and Sub-sovereign obligations from an Eligible Non-EEA Country with credit ratings below step 1 but at least step 2 may also be included in the cover pool provided that in total they do not exceed 20% of the nominal amount of outstanding ACS.

Designated mortgage credit institutions

Those assets eligible for inclusion in the cover pool of a designated mortgage credit institution ("mortgage credit assets") are financial obligations (collectively, "mortgage credits"), including obligations given as a guarantor or surety and indirect or contingent obligations, in respect of money borrowed or raised (whether in the form of a security that represents other mortgage credit that is securitised or not) that are secured by a mortgage, charge, or other security on residential or commercial property that is located in any EEA country or any Eligible Non-EEA Country. This is subject to a concentration limit, for mortgage credit assets secured on commercial property, of 10% of the total prudent market value of all mortgage credit assets and substitution assets in the cover pool. Non-performing mortgage credit assets may not be included in a cover pool. Furthermore, a mortgage credit asset may not be counted as part of a cover pool if a building related to that mortgage credit asset is being or is to be constructed until the building is ready for occupation as a commercial or residential property. A mortgage credit institution may also include securitised mortgage credits in its cover pool subject to certain credit quality and other criteria and a concentration limit of 10% of the aggregate value of the related outstanding ACS. To date, designated mortgage credit institutions have not included securitised mortgage credit assets in their cover pools.

Substitution assets

Substitution assets can be included in any cover pool provided that they comply with applicable CRR requirements and certain other restrictions. These are deposits having a minimum credit rating of Step 2 and a maximum maturity of 100 days with eligible financial institutions.

IV. VALUATION AND LTV CRITERIA

Designated public credit institution

Public credit assets maintained in the cover pool of a designated public credit institution are ascribed a prudent market value equal to 100% of the amount of the related public credit outstanding on the date of valuation.

Designated mortgage credit institution

The maximum prudent LTV levels for mortgage credit assets included in the cover pool of a mortgage credit institution are 75% for mortgage credit assets backed by residential property and 60% for those backed by commercial property. Prudent LTV levels for mortgage credit assets in the cover pool can exceed the 75% threshold, however the balance of the mortgage credit above this threshold is disregarded for valuation purposes. As noted in Section III, the inclusion in the cover pool of mortgage credit assets secured on commercial property is restricted to 10% of the prudent market value of all mortgage credit assets and substitution assets included in the cover pool at any time. Cover pool data indicates however, that designated mortgage credit institutions have not included assets secured on commercial property in their cover pools to date.

A designated mortgage credit institution is first required to determine the market value of a property asset at the time of origination of the mortgage credit asset secured on it. It is market practice for such property valuations to be conducted by independent valuers. The designated mortgage credit institution is then required to calculate the prudent market value of such property asset at the time of inclusion of the related mortgage credit asset in the cover pool and also at such intervals (at least once per year) as may be specified by the CBI. In addition, a designated mortgage credit institution is required to calculate the prudent market value of mortgage credit assets and securitised mortgage credits included in the cover pool on a quarterly basis, or more frequently if so instructed by the CAM, for the purposes of demonstrating compliance with the asset-liability and over-collateralisation requirements of the ACS Acts. In practice, the prudent market value of relevant property assets is calculated on a quarterly basis also as this calculation forms part of the valuation process for mortgage credit assets.

For these subsequent calculations, the designated mortgage credit institution must apply the house price index published by permanent tsb and/or the house price index published by the Irish Central Statistics Office (depending on the date of origination) to the valuation obtained at origination, with same being verified by the CAM on a monthly basis.

V. ASSET-LIABILITY MANAGEMENT

The ACS Acts include important asset-liability controls to minimise various market risks.

Duration matching: The weighted average term to maturity of a cover pool cannot be less than that of the related ACS.

Over-collateralisation: The prudent market value of the cover pool must be at least 3% greater than the total of the principal amount of the related ACS in issue (see also *Over-collateralisation* below).

Interest matching: The amount of interest payable on cover assets over a 12-month period must not be less than the amount of interest payable on the related ACS over the same 12-month period.

Currency matching: Each cover asset must be denominated, after taking into account the effect of any cover assets hedge contract, in the same currency as the related ACS.

Interest rate risk control: The net present value changes on the balance sheet of an ACS Issuer arising from (i) 100bps upward shift, (ii) 100bps downward shift and (iii) 100bps twist, in the yield curve, must not exceed 10% of the ACS Issuer’s total own funds at any time.

Hedge contracts

Hedge contracts are used in the cover pool to minimise risks on interest rates, currency exchange rates, credit or other risks that may adversely affect the ACS Issuer's business activities that relate to an ACS or cover assets. All such hedge contracts are required to be entered on the cover register by the ACS Issuer. Once so entered, pool hedge counterparties rank as preferred creditors, pari passu with the ACS holders, provided they are not in default of their financial obligations under that hedge contract. Upon the insolvency of an ACS Issuer, a hedge contract will remain in place subject to its terms. Any collateral posted under a hedge contract by a pool hedge counterparty must be recorded on a separate register maintained by the ACS Issuer.

Over-collateralisation

The ACS Acts prescribe a minimum over-collateralisation of ACS for designated mortgage credit institutions and designated public credit institutions of 3% calculated on a present value basis. It is also possible for ACS Issuers to commit by contract to higher minimum levels of over-collateralisation and the market practice has been for ACS Issuers to contractually commit to higher levels. The CAM is responsible for monitoring the levels of legislative and contractual over-collateralisation. Upon an ACS Issuer insolvency, ACS holders will benefit from any cover assets which make up the over-collateralisation to the extent of their claims.

VI. TRANSPARENCY

Disclosure in financial statements

All ACS Issuers are required to make specific disclosures in relation to cover assets included in their cover pools in their annual financial statements.

Designated public credit institutions

A designated public credit institution is required to disclose as at the date to which its financial statements are made up:

- the geographic location of its public credit assets and the volume and percentage of assets in each such location; and
- details of public credit assets secured on loans to multilateral development banks and international organisations and the volume and percentage of such assets.

Designated mortgage credit institutions

A mortgage credit institution is required to disclose, as at the date to which its financial statements are made up, details of:

- the number of mortgage credit assets, broken down by amount of principal outstanding ;
- volume and percentage of assets in each geographic location;
- the number and principal amounts outstanding of non-performing mortgage credit assets;
- whether or not any persons who owed money under mortgage credit assets had, during the immediately preceding financial year (if any), defaulted in making payments in respect of those assets in excess of EUR 1,000 (so as to render them non-performing for the purposes of the ACS Acts), and if so, the number of those assets that were held in the cover pool;
- the number of non-performing mortgage credit assets replaced with other assets;
- the total amount of interest in arrears in respect of mortgage credit assets that has not been written off;
- the total amounts of principal repaid and interest paid in respect of mortgage credit assets; and
- the number and the total amount of principal outstanding on mortgage credits that are secured on commercial property.

Covered Bond Label and National Transparency Template

Mortgage sector ACS Issuers have agreed a National Transparency Templates ("NTT") for the purposes of the ECBC's Covered Bond Label (the "Label"). The NTT tracks the list of recommended transparency items set out in the ECBC's Guidelines for National Transparency Templates. In particular, it includes a summary of the loans in the cover pool, a breakdown of the cover pool by loan balance, an analysis of arrears, a summary of outstanding ACS and cover pool valuation metrics, including prudent market valuation and over-collateralisation levels. NTTs are completed and published on a quarterly basis together with access to archive data going back for a period of at least 7 years.

To date, two designated mortgage credit institutions have applied for and obtained the Label in respect of their ACS issuance programmes.

VII. COVER POOL MONITOR AND BANKING SUPERVISION

One of the key features of the ACS legislation is the rigorous monitoring role undertaken by the CAM. The CAM is appointed by the ACS Issuer with such appointment being approved by the CBI.

There are strict eligibility requirements for CAMs. A CAM must be a body corporate or partnership, comprising personnel or partners who are members of a professional representative body. It must demonstrate to the CBI that it is experienced and competent in (i) financial risk management techniques, (ii) regulatory compliance reporting and (iii) capital markets, derivatives, and, as applicable, public credit business and mortgage credit business. The CAM must also demonstrate that it has sufficient resources at its disposal and sufficient academic or professional qualifications and experience in the financial services industry to satisfy firstly, the designated credit institution and secondly, the CBI, that it is capable of fulfilling this role.

The CAM is responsible for monitoring the cover pool, the ACS Issuer's compliance with specific provisions of the ACS Acts and reporting any breaches of same to the CBI. The CAM issues regular reports to the ACS Issuer (every 1-4 weeks) and submits a report on a quarterly basis to the CBI.

Some of the CAM's principal obligations include: ensuring that the matching requirements of the ACS Acts with respect to the cover assets and the ACS are met; ensuring that the asset eligibility requirements are met; approving any inclusion in or removal from the cover register, of a cover asset, ACS or hedge contract; checking that the level of substitution assets included in the cover pool does not exceed the prescribed percentage; and ensuring that the legislative and contractual levels of over-collateralisation are maintained.

The CBI is given statutory responsibility for supervising ACS Issuers. The CBI may, with the consent of the Minister for Finance, revoke the registration of an ACS Issuer and/or suspend its business if such ACS Issuer breaches any provision of the ACS Acts. In addition, the CBI has wide-ranging powers under the Irish Central Banking legislation to impose significant fines and administrative sanctions on ACS Issuers and/or their senior management for contraventions of the ACS Acts.

VIII. SEGREGATION OF COVER ASSETS AND BANKRUPTCY REMOTENESS OF COVERED BONDS

As noted above under section II, an ACS Issuer holds its cover assets on its balance sheet. However, the cover assets are ring-fenced from the other assets of the ACS Issuer for the benefit of ACS holders by virtue of (i) their being recorded in the cover register, and (ii) a statutory preference created by the ACS Acts.

Segregation: Cover register

Each ACS Issuer must maintain a cover register including the details of its ACS in issue, the cover assets and substitution assets backing its ACS and any cover assets hedge contracts in existence. The cover register is important as a cover asset or a cover assets hedge contract cannot be described as such unless and until it is recorded on the register. Their registration is prima facie evidence of such assets and hedge contracts being included in the cover pool, entitling the ACS holders and pool hedge counterparties to benefit from the insolvency protection specified in the ACS Acts in respect of such assets and hedge contracts. An ACS Issuer may only remove or amend a register entry with the consent of the CAM or the CBI which further safeguards the interests of ACS holders.

Preferential treatment of ACS holders

Once a cover asset has been entered in the cover register, it will remain a cover asset for the benefit of ACS holders and other preferred creditors until the CAM or the CBI has consented to its removal from the cover register and consequently, the cover pool. Cover assets included in a cover pool do not form part of the assets of the ACS Issuer for the purposes of insolvency until such time as the claims of ACS holders and other preferred creditors under the ACS Acts have been satisfied.

If the claims of the ACS holders (and other preferred creditors, including the pool hedge counterparties) are not fully satisfied from the proceeds of the disposal of the cover assets, such parties are, with respect to the unsatisfied part of their claims, to be regarded as unsecured creditors in the insolvency process.

Impact of insolvency proceedings on ACS and hedge contracts

Upon insolvency of an ACS Issuer, all ACS issued remain outstanding and all cover assets hedge contracts will continue to have effect, subject in each case, to the terms and conditions of the documents under which they were created.

The claims of ACS holders on the cover pool are protected by operation of law. Cover assets and hedge contracts that are included in a cover pool are not liable to interference by a bankruptcy custodian or similar person whether by attachment, sequestration or other form of seizure, or to set-off by any persons, that would otherwise be permitted by law so long as claims secured by the insolvency provisions of the ACS Acts remain unsatisfied. ACS holders have recourse to cover assets ahead of all other non-preferred creditors regardless of whether the claims of such other creditors are preferred under any other enactment or any rule of law and whether those claims are secured or unsecured.

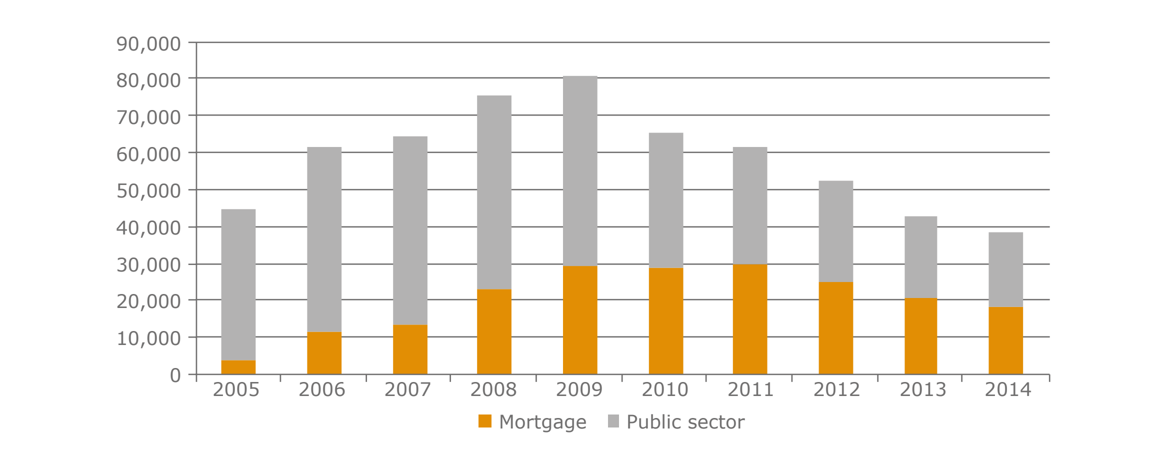
The role of the manager and access to liquidity in case of insolvency

The ACS Acts makes provision for the management of the asset covered securities business of an ACS Issuer upon an ACS Issuer insolvency through the services of the Irish National Treasury Management Agency (“NTMA”). If no suitable manager can be found by the CBI or the NTMA, the NTMA will attempt to locate an appropriate body corporate as a new parent entity for the ACS Issuer. Failing that, the CBI will appoint the NTMA to act as a temporary manager until a suitable manager or new parent entity is found. Upon appointment, a manager will assume control of the cover assets, the asset covered securities business and all related assets of the ACS Issuer. The manager is required to manage the ACS business of the ACS Issuer in the commercial interests of the ACS holders and the pool hedge counterparties. The manager will have such powers as may be designated to it by the CBI under its notice of appointment. It is possible for a manager to obtain a liquidity facility through the use of a hedge contract, such hedge contract if recorded in the cover register would constitute a cover assets hedge contract for the purposes of the ACS Acts and the pool hedge counterparty would rank pari passu with ACS holders and any other pool hedge counterparties.

IX. RISK-WEIGHTING AND COMPLIANCE WITH EUROPEAN LEGISLATION

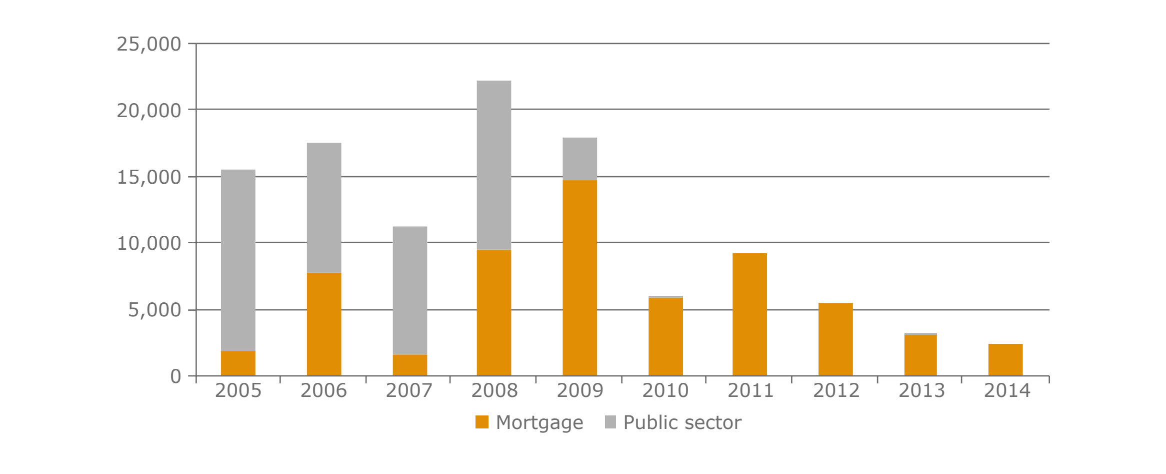
The ACS meet the requirements of Article 52(4) UCITS. The eligibility of cover assets set out in the ACS Acts also match the criteria for the preferential risk-weighting of covered bonds set out in the CRR.

> Figure 1: Covered Bonds Outstanding, 2005-2014, EUR m



Source: EMF-ECBC

> Figure 2: Covered Bonds Issuance, 2005-2014, EUR m



Source: EMF-ECBC

Issuers: There are five ACS Issuers with outstanding covered bonds – Bank of Ireland Mortgage Bank, DEPFA ACS BANK, EAA Covered Bond Bank plc, AIB Mortgage Bank and EBS Mortgage Finance.

ECBC Covered Bond Comparative Database: http://ecbc.eu/framework/28/Asset_Covered_Securities_-_ACS.

Covered Bond · Label · : AIB Mortgage Bank ACS (Asset Covered Securities); Bank of Ireland Mortgages ACS (Asset Covered Securities).

3.17 ITALY

By Alfredo Varrati, Italian Bankers Association

I. FRAMEWORK

The Italian Legislator enacted a new regulation (Law no. 80/2005) in May 2005, by means of which two specific articles (article 7-*bis* and article 7-*ter*) were inserted into the existing Italian securitization law (Law no. 130/1999), providing for covered bonds.

The legislator decided to supplement Law no. 130/99 rather than adopt a separate and autonomous law/legal framework, in light of the markets' and international operators' positively assessing Italian securitization law. They found that the law introduced an established and reliable legal framework (e.g. from a standpoint of "bankruptcy remoteness").

Pursuant to paragraph 5 of the first of the two articles mentioned above, on 14 December 2006, the Ministry of Economy and Finance issued secondary rules in relation to some key issues of the structure. In particular, implementing rules have been enacted with respect to the type of assets eligible for the cover pool, the maximum allowed ratio between transferred assets and issuable securities, the type of guarantee to be provided to bondholders by the SPV.

As for the last procedural step, which formally allows Italian banks to start issuing covered bonds, the Bank of Italy enacted its implementing measures on 17 May 2007, in relation to the requirements to be complied with by issuing banks, the criteria to be adopted to evaluate the cover assets and the relevant formalities to integrate such assets, as well as the formalities to check that the banks are complying with their obligations under the same article 7-*bis*, also through auditors.

II. STRUCTURE OF THE ISSUE OF COVERED BONDS

Pursuant to the abovementioned article 7-*bis*, the structure of a covered bond transaction is as follows:

1. a bank transfers eligible assets to a special purpose vehicle (SPV), whose sole corporate purpose is the purchase of such assets and the granting of a guarantee for the issued securities over which bondholders have a senior claim;
2. the SPV purchases the transferred assets by means of a loan granted or guaranteed to it by a bank (not necessarily the same bank transferring the assets);
3. the bank transferring the assets (or another bank) issues covered bonds;
4. the assets purchased by the SPV are applied to satisfy the rights attaching to the covered bonds and the counterparties of derivative agreements entered into for hedging the risks related to the assets, and to pay the costs of the transaction.

According to the Bank of Italy's regulation, covered bonds can be issued only by banks with the following prerequisites:

> own funds not lower than EUR 250 mln

> a total capital ratio not lower than 9%

It is also provided that these requisites must be fulfilled by the transferring banks as well (i.e. cover pool providers), if they are not the issuers.

There are no business restrictions to the issuer's activity, hence there is no special banking principle that needs to be enforced. Bondholders hold a preferential claim on the cover assets and the covered bonds are direct, unconditional obligations of the issuer.

III. COVER ASSETS

As provided for by paragraph 1 of Article 7-bis of the securitization law, the eligible assets as coverage for covered bonds are:

a) residential mortgage loans with a maximum LTV of 80% or commercial mortgage loans with a maximum LTV of 60%;

b) claims owed by (or guaranteed by) the following entities, up to 10% of the cover pool:

> public entities of EEA member countries and Switzerland with a maximum risk-weight of 20%;

> public entities of non-EEA member countries with a risk weight of 0%;

> other entities of non-EEA member countries with a risk weight of 20%.

c) notes issued under a securitisation transaction backed (for a minimum of 95%) by the claims under the abovementioned letters a) and b), that qualify for the credit quality step 1 under the Standardised approach. In case the covered bonds are backed by notes issued under a securitisation transaction for more than 10% of the issuance nominal value, the following additional conditions must be fulfilled:

> the residential or commercial mortgage loans must have been originated within the banking group of the issuer;

> the issuer or an entity consolidated in the same banking group holds the risk underlying the entire junior tranche;

> the issuer and the SPV are able to verify, on an ongoing basis, the eligibility and the volumes of the securitized assets and to provide the asset monitor with all the relevant information it may require to perform its controls.

As regards the transferring of such eligible assets to the SPV, the Bank of Italy sets different limits according to the different regulatory capital levels of the issuer (see Figure 1)

> Figure 1

Regulatory capital level		Transfer limitations
Class A	Tier 1 ratio ≥ 9% and Core Equity Tier 1 ratio ≥ 8%	No limitations
Class B	Tier 1 ratio ≥ 8% and Core Equity Tier 1 ratio ≥ 7%	Eligible assets can be transferred up to 60% of total
Class C	Tier 1 ratio ≥ 7% and Core Equity Tier 1 ratio ≥ 6%	Eligible assets can be transferred up to 25% of total

As provided for by the secondary legislation enacted by the Italian Ministry of Economy, assets must at least equal liabilities both on the nominal and NPV bases, and the revenues arising from cover assets must be sufficient to pay coupons to bondholders and to cover the cost of derivative transactions.

The integration of cover assets can be performed through:

1. the transfer of additional eligible assets to the pool;
2. the opening of deposit accounts at banks located in an EEA member country, or in other countries with a 0% risk-weight;
3. the transfer of banks' own debt securities (with maturity of less than 1 year) to the pool.

It is also provided that integration through assets under points 2 and 3 is allowed only up to 15% of the cover pool's nominal value. With respect to such provisions, the Bank of Italy established that integration is allowed only to:

- maintain the ratio of issued bond to cover assets up to the abovementioned level provided for by the Ministry of Economy;
- in case of voluntary over-collateralisation, maintain the ratio of issued bond to cover assets up to the contractually-agreed limit;
- respect the abovementioned 15% limit for eligible supplementary assets.

IV. ASSET-LIABILITY MANAGEMENT

In order to allow the SPV to fulfil its obligations, issuing banks are required to adopt proper asset-liability management techniques and to perform specific controls at least every 6 months, to ensure that the proceeds from the cover pool assets are always sufficient to pay the coupons on the covered bonds, and the overall cost of the transaction.

V. COVER POOL MONITOR AND BANKING SUPERVISION

As far as regulatory supervision is concerned, the Bank of Italy sets and monitors, on an ongoing basis, the abovementioned specific eligibility requirements for issuing banks which are stricter than those provided for traditional banking activities. These parameters require, in particular, own funds of at least €250 million and a consolidated total capital ratio of at least 9%. It is also provided that eligible assets may be assigned to the SPV only subject to a series of restrictions, graduated based on the total capital ratio and Tier 1 ratio at the consolidated level.

Although in some European countries the issuance of covered bond is subject to a "licence" granted by the Supervisory Authority upon the fulfilment of specific requirements, the Italian legislator has decided to make a different choice. Rather than introducing a "licence" system, it has defined a series of requirements and limitations to issuance which together can be de facto considered as the objective basis upon which to grant an issuance authorization. Moreover, it must be considered that such requirements and limitations are in most cases stricter than those required by other regulatory frameworks.

Furthermore, Italian regulation prescribes that the monitoring of the regularity of the transaction and of the integrity of the collateral securing investors must also be performed by an external asset monitor (AM) appointed by the issuer. The AM must be an auditing firm possessing the professional skills required to perform such duties and must be independent from the bank engaging it (e.g. it cannot be the same firm appointed to audit the accounts of the issuing bank) and of any other person participating in the transaction. It has to report at least once a year to the Board of Directors and to the internal audit department of the bank.

Although no specific reporting to the Bank of Italy is prescribed by law, in practice the AM will report to the Supervisor any material anomaly found. It must also be considered that the AM's report is reviewed by the bank's auditor which reports regularly to the Bank of Italy. Should such report contain negative evaluations, the bank's auditor is obligated to bring the issue to the Bank of Italy's attention.

In general terms, specific control requirements on banks issuing covered bonds find their primary source from EU and national legislation. Additionally, in consideration of the peculiarities of a covered bond transaction, the Bank of Italy assigns to issuers the primary responsibility to evaluate the risk involved in the operations, to arrange a proper control mechanism and to ensure its functioning through the time. In particular, at least every six months and for each operation, issuers have to check: i) the quality of the cover pool; ii) compliance with the predetermined ratio between outstanding covered bonds and cover assets; iii) compliance with transfer limitations and asset integration requirements; iv) the performance of any derivative agreement entered into in order to hedge risks.

As far as information flows are concerned, it is provided that issuing/transferring banks shall acquire, from all the parties involved in the structuring of the covered bonds, information relating to:

> the possessory titles of the transferred assets (in order to be able to track down each borrower whose loan has been transferred to the SPV);

> the performance of the transferred assets (in order to monitor the "health" of the cover assets).

This information is necessary to issuing/transferring banks in order to perform both the abovementioned controls in terms of cover pool monitoring and the regulatory reporting (i.e. reporting of defaulted loans to the Bank of Italy's *Centrale dei Rischi*).

VI. TRANSPARENCY

In 2012, the main Italian OBG issuers, coordinated by the Italian Banking Association, worked together to create a transparency template, consistent with the guidelines of the ECBC Label Initiative. The OBG transparency template is available online on the Covered Bond Label website (https://www.coveredbondlabel.com) and each participating OBG issuer has published a completed version on its own website.

VII. SEGREGATION OF COVER ASSETS AND BANKRUPTCY REMOTENESS OF COVERED BONDS

As provided for by the secondary legislation enacted by the Italian Ministry of Economy, the guarantee granted by the SPV to the covered bondholders, must be irrevocable, first-demand, unconditional and independent from the issuing bank's obligations on the covered bonds. It will be callable upon non-payment and bankruptcy of the issuing bank, and it will be limited to cover pool asset value to ensure bankruptcy remoteness of the SPV.

The SPV is a financial intermediary, registered in the "special list" provided for by article 107 of the Banking Law, and therefore subject to the Bank of Italy's supervision.

Covered bondholders will have the right, represented exclusively by the SPV, to file a claim with the issuing bank for full repayment of the covered bonds. In case of liquidation of the issuing bank, the SPV will be exclusively responsible to make payments to covered bondholders (as well as other counterparties) and will represent covered bondholders in proceedings against the issuing bank.

All the amounts obtained as a result of the liquidation procedure will become part of the cover pool and therefore used to satisfy the rights of covered bondholders. The redemption of the subordinated loan granted by the issuer of the covered bonds to the SPV is junior to any outstanding claims of covered bondholders, swap counterparties and transaction costs.

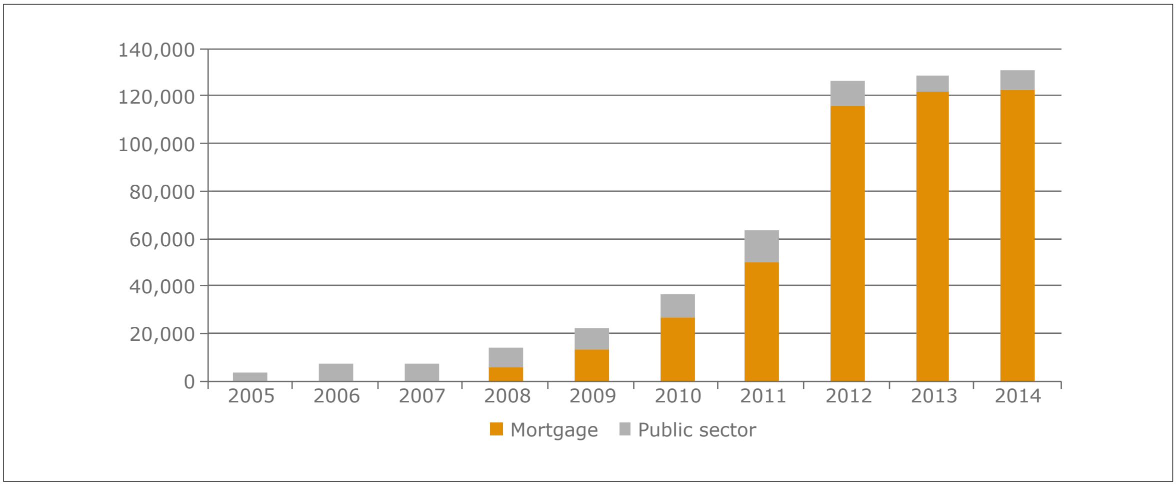
In case the proceeds obtained as a result of the liquidation procedure are insufficient to meet the obligations to bondholders in full, investors would still have an unsecured claim against the issuer for the shortfall.

VIII. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

The legislation when taken together with the practices, processes and procedures across the industry should fall within the criteria of Article 129 (7) of the Capital Requirements Regulation (CRR), also considered that a recent update of Bank of Italy's OBG regulation establishes that the asset monitor must verify, among other things, that the information disclosed to investor as per Article 129 (7) of the CRR are complete, accurate and provided in a timely manner. Italian covered bonds fulfil both the criteria of Article 52(4) UCITS and Article 129(1) CRR.[1] They are also eligible in repo transactions with the Bank of Italy.

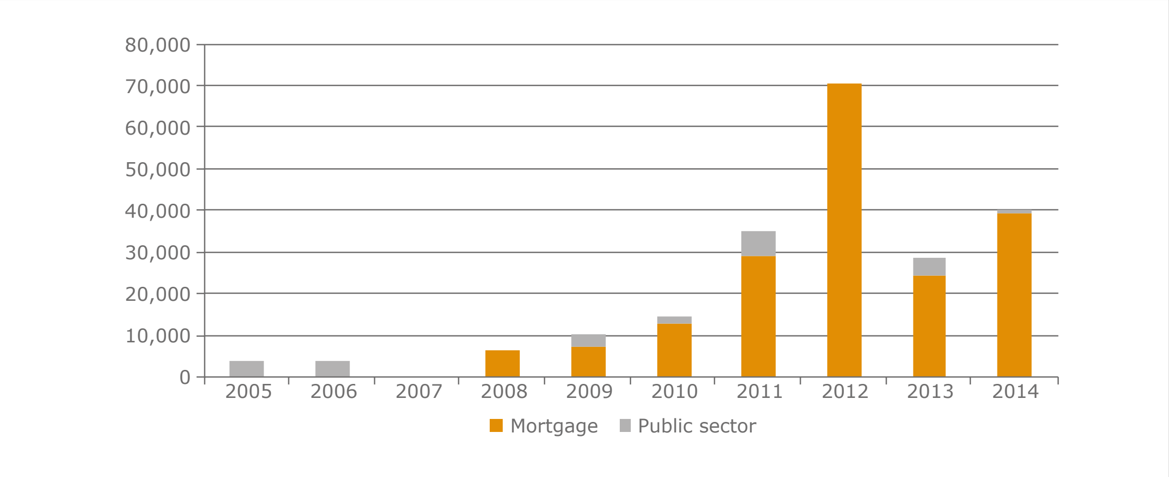
[1] Please click on the following link for further information on the UCITS Directive and the Capital Requirements Regulation (CRR): http://ecbc.hypo.org/Content/default.asp?PageID=504#position.

> Figure 1: Covered Bonds Outstanding, 2005-2014, EUR m



Source: EMF-ECBC

> Figure 2: Covered Bonds Issuance, 2005-2014, EUR m



Source: EMF-ECBC

Issuers: Unicredit, Intesa Sanpaolo, Banca Popolare di Milano, Monte dei Paschi di Siena, Banco Popolare, Cariparma, UBI, Mediobanca, Deutsche Bank, Carige, Bper, Credem, BNL, Banca Popolare di Sondrio.

ECBC Covered Bond Comparative Database: http://ecbc.eu/framework/31/Obbligazioni_Bancarie_Garantite_-_OBG.

Covered Bond · Label · : Banca Carige S.p.A. Credit Home/Commercial Loan; Intesa Sanpaolo S.p.A. CB Ipotecario S.r.l.; Intesa Sanpaolo S.p.A. CB Pubblico S.r.l.; UniCredit BpC Mortgage s.r.l., Cariparma OBG S.r.l.

3.18 LATVIA[1]

By Kaspars Gibeiko

I. FRAMEWORK

In Latvia, the legal basis for covered bond issuance is the Law on Mortgage Bonds (HKZL – Hipotekāro ķīlu zīmju likums) from 10 September 1998 and subsequent amendments to the HKZL (1 June 2000, 5 July 2001, 6 November 2002 and 25 October 2006). The insolvency and bankruptcy procedure is captured both by the HKZL (Section 4) and the Law on Credit Institutions (Articles 561, 161 and 191).

II. STRUCTURE OF THE ISSUER

There is no specialised banking principle in Latvia. As a result every registered bank can issue mortgage-backed covered bonds. The minimum requirements a bank must fulfil in order to issue mortgage bonds are as follows:

> Tier1 and Tier2 capital should be not less than stated in the Law on Credit Institutions;

> Provision of the banking services specified in Article 1, Clause 4 of the Law on Credit Institutions without any restrictions imposed by the Financial and Capital Market Commission (FCMC);

> Submission of rules approved by the bank's supervisory board regarding the valuation of the real estate to be mortgaged and the management of the mortgage bond cover register to the FCMC.

The issuer holds the cover assets on his balance sheet and the cover assets are not transferred to a different legal entity. All obligations from mortgage bonds are obligations of the issuing bank as a whole, to be paid from all the cover assets of the issuer. In the case of insolvency, the cover pool is segregated by law from the general insolvency estate and is reserved for the claims of the mortgage bond holders.

The HKZL does not prescribe the issuing bank to have separate employees to manage the cover pool, but it prescribes that the cover assets are managed separately from other assets of the issuer. Therefore, if employees of the bank are involved both in the management of the cover assets and the management of non-cover assets, separation of the duties and responsibilities should be clearly stipulated in the bank's by-laws and internal procedures. There are also no specific requirements regarding the outsourcing of the management of cover assets in the Latvian covered bond legislation.

III. COVER ASSETS

Cover assets can be eligible mortgage loans or loans secured by either guarantees of the Latvian Government or guarantees of the local governments.

Up to 20% of the nominal volume of outstanding mortgage bonds and interest expenses (substitute cover) may consist of:

> cash;

> balances with the central banks of the EU member states; and

> securities issued and guaranteed by the EU member state governments up to 95% of their market value whilst not exceeding the face value of these securities or securities issued by the EU member state's financial institution and traded on the EU regulated securities market up to 95% of their market value whilst not exceeding the face value of these securities.

The eligible mortgage assets are restricted in geographical scope to the extent that a property that secures a mortgage loan should be registered with the EU member state's property register. This means that only properties which are registered in the EU member state can be used as collateral for mortgage loans included

[1] Please note that due to no legislative changes at national level, this article is the same as the one published last year.

in the cover pool. The loans secured by Latvian sovereign and sub-sovereign guarantees are not restricted by geographical scope, but they are restricted by loan purpose; loans which finance public and infrastructure projects are eligible.

Derivatives are eligible for cover pool inclusion for the purpose of mitigating currency – and interest rate risk. The volume of derivatives is not limited and the general documentation used is the standard for derivatives.

IV. VALUATION AND LTV CRITERIA

Property valuation is regulated in Article 15 of the HKZL. Property valuation is carried out according to the international valuation standards. The basis for property valuation is market value. Professionals responsible for the determination of the market value of a property must be in possession of a relevant professional qualification. In addition to that, Article 151 (introduced by the amendment to the HKZL on 25th of October 2006) stipulates that the market value of property registered in the EU member state is determined by the persons who have received professional, real estate valuation, licence according to the legislation of particular EU member state.

The issuer is responsible for the monitoring of the property value. The frequency of monitoring is not defined by the HKZL, but it is prescribed by the regulations of the FCMC and by-laws of the issuer.

Article 14 of the HKZL stipulates that a mortgage loan together with debts previously registered with the national property register may not exceed 75% of the market value of residential property and 60% of the market value of other type of property.

V. ASSET – LIABILITY MANAGEMENT

Article 9 of the HKZL stipulates the following requirements to the asset-liability management of the cover pool:

> the total volume of the cover assets must be larger than the total volume of outstanding mortgage bonds at their face value by at least 10% of the risk weighted value of the cover assets, where risk weighted value of the cover assets is calculated based on specific weights of each type of the cover assets;

> The currency of the cover assets and that of the outstanding mortgage bonds may differ only if the issuer has taken all the necessary measures to prevent the currency risk in the cover pool;

> The total interest income from the cover assets must exceed the total interest expenses on outstanding mortgage bonds;

> The cash-flows from the outstanding mortgage bonds (in accordance with the mortgage prospectus) must always be covered by the cash-flows from the cover assets in terms of volumes and maturities;

> The issuer of the covered bonds has to prepare a report on the cash-flow mismatches and submit it to the FCMC on a semi-annual basis.

The latest amendment to the HKZL stipulates that the issuer should separate loans secured by a mortgage and loans secured by central or municipal governments. This requirement was introduced in order to separate mortgage bonds and public sector bonds.

VI. COVER POOL MONITOR AND BANKING SUPERVISION

The Latvian covered bond legislation does not require the appointment of a special entity to monitor the cover pool. Instead, the cover pool is managed by the issuing bank and it is the issuing bank's responsibility to set up a system to ensure that the cover pool is managed properly. In some banks, monitoring of the cover pool is executed by the internal audit department.

The FCMC supervises cover pools. It inspects cover pool (quality and eligibility of the cover assets, quality of the asset-liability management) during regular banking supervisory audits which are carried out on average every two years.

The FCMC has the right to suspend the issue of mortgage bonds under the following circumstances:

> The issuing bank does not comply with the conditions laid down in the Law on Mortgage Bonds;

> The issuer does not ensure that the redemption and interest payments on outstanding mortgage bonds are always covered by the principal and interest payments of the cover assets of a higher value;

> By-laws on the valuation of properties securing the mortgage assets and by-laws on the management of cover pool submitted to the FCMC are not followed.

VII. SEGREGATION OF COVER ASSETS AND BANKRUPTCY REMOTENESS OF COVERED BONDS

A cover register facilitates the identification of the cover assets, because all the cover assets, including substitute cover as well as derivatives, are recorded in the cover register. The type and scope of the information recorded regarding the cover assets in the cover register are determined by FCMC regulations.

The legal effect of registration is the fact that in the case of insolvency of the issuer, the assets which form part of the separate legal estate can be identified and all assets recorded in the cover register qualify as part of this separate legal estate.

Asset segregation

A cover pool is a part of the general estate of the issuing bank as long as the issuer is solvent. If the insolvency proceedings are opened, by operation of law, the assets recorded in the cover register are excluded from the insolvency estate of the issuer. Those assets will not be affected by the opening of the insolvency proceedings, but automatically form a separate legal estate.

After the opening of the insolvency proceedings, a special cover pool administrator initiated by the FCMC and appointed by court carries out the administration of the cover assets.

Impact of insolvency proceedings on covered bonds and derivatives

Covered bonds do not automatically accelerate when the issuing institution becomes insolvent, but will be repaid at the time of their contractual maturity. The same applies to derivatives which are registered in the cover register and form part of the cover pool. During an insolvency procedure, derivatives’ counterparties have the same rights as the holders of mortgage bonds.

Preferential treatment of covered bond holders

Covered bond holders enjoy a preferential treatment as the HKZL and the Law on Credit Institutions stipulates the separation of the cover assets in a case of the insolvency of the issuing bank. According to Article 191 of the Law on Credit Institutions, mortgage bond holders have the first access rights to the cashflows generated by the assets recorded in the cover register.

In the case of insolvency of the issuer, it is forbidden to modify the content of the cover register and all cash flows from the cover assets must be accrued within it. As long as there is sufficient cover, a moratorium on the insolvency’s estate cannot delay the cash flows from the cover assets and, therefore, endanger the timely payment of covered bond holders.

Only in the case of over-indebtedness or insolvency of the cover assets shall the FCMC file an application to court regarding the insolvency of the cover register (Article 26 of the HKZL). Insolvency of the cover pool is the only catalyst which could the trigger acceleration of covered bond.

Access to liquidity in case of insolvency

With the appointment of the cover pool administrator, the right to manage the cover assets is transferred to him by law. Thus, the cover pool administrator has first access to the cover assets and collects the cash flows according to their contractual maturity.

The cash-flows from the cover assets may only be used for the following purposes and the use of assets in any other manner is inadmissible:

- Disbursements to mortgage bond holders if the term for interest payments or mortgage bond redemption has become due;
- Purchase of mortgage bonds issued by the issuer itself with their subsequent redemption in the public securities market at a price not exceeding the face value of the mortgage bonds if the remaining cover assets are sufficient to cover outstanding mortgage bonds;
- Payments under derivatives' agreements concluded on the cover asset risk mitigation, provided that the contracting parties have met the conditions of such agreements.

The cover pool administrator is permitted, in case of the insolvency of the issuer, to exceed the substitute cover limit.

No specific regulation exists with respect to the insolvency remoteness of voluntary overcollateralisation. However, the cover pool administrator is not allowed to use voluntary overcollateralisation until all payments to mortgage bond holders are made fully and on time.

The cover pool administrator may carry out legal transactions in respect of the cover pools in so far as this is necessary for an orderly settlement of the cover pool and for the full and timely satisfaction of the cover pool's creditors.

Sale and transfer of mortgage assets to other issuers

The HKZL and the Law on Credit Institutions provide that the cover assets in a case of insolvency of issuer are transferred to other bank chosen by the FCMC. The bank to which the cover assets are transferred, also takes responsibility for all the obligations arising from outstanding mortgage bonds.

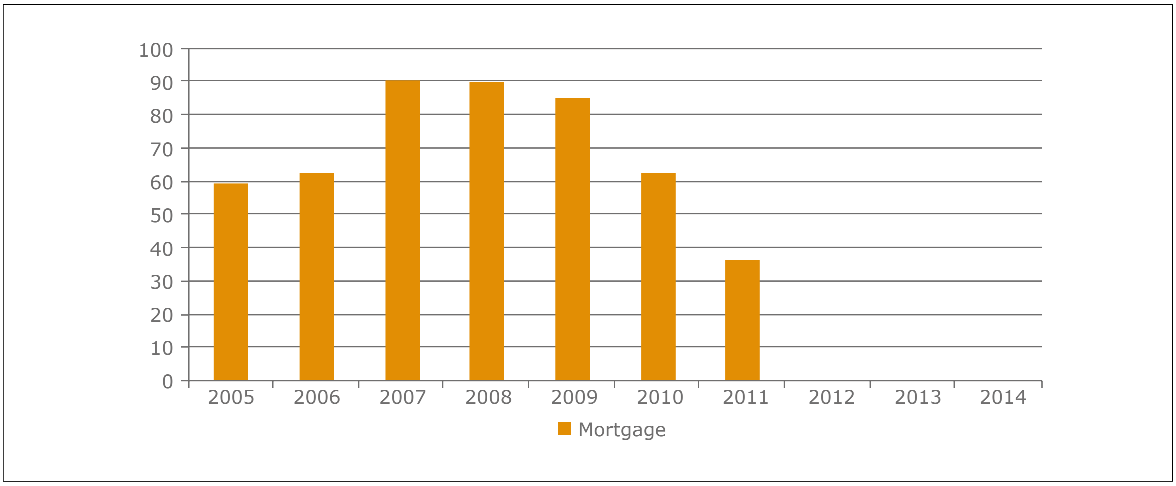
VIII. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

The legislation when taken together with the practices, processes and procedures across the industry should fall within the criteria of Article 129 of the Capital Requirements Regulation (CRR). Latvian mortgage bonds comply with the requirements of Article 52(4) UCITS Directive as well as with those of Article 129 CRR.[2] The current risk-weight applied to mortgage bonds in Latvia is 20%.

Latvian investment legislation allows mutual funds to invest up to 25% of their assets in mortgage bonds and pension funds – up to 10% of their assets.

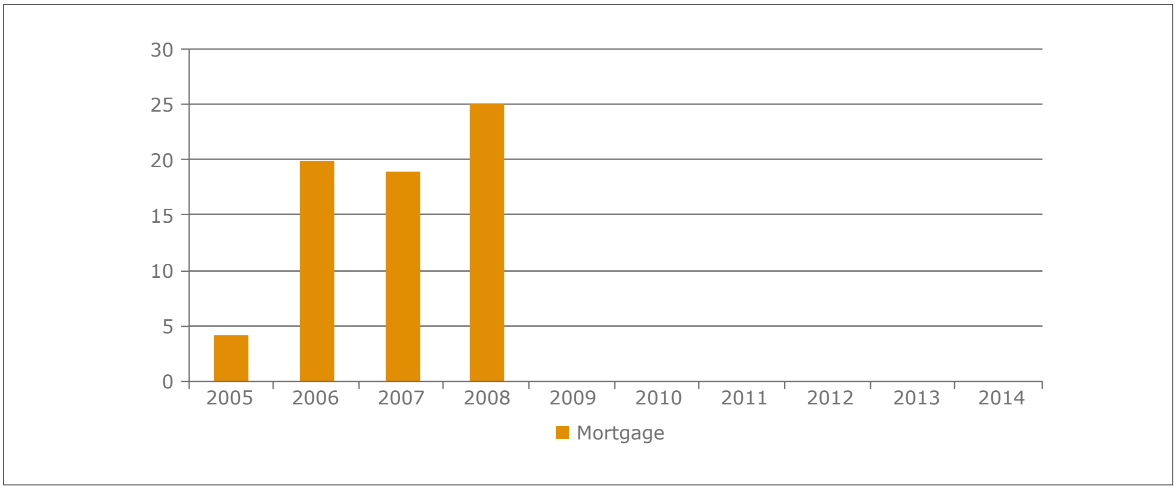
[2] Please click on the following link for further information on the UCITS Directive and the Capital Requirements Regulation (CRR): http://ecbc.hypo.org/Content/default.asp?PageID=504#position.

> Figure 1: Covered Bonds Outstanding, 2005-2014, EUR m



Source: EMF-ECBC

> Figure 2: Covered Bonds Issuance, 2005-2014, EUR m



Source: EMF-ECBC

3.19 LUXEMBOURG

By Matthias Melms, NORD/LB and Frank Will, HSBC & Chairman of the ECBC EU Legislation Working Group

I. FRAMEWORK

The issuance of Lettres de Gage is regulated by Articles 12-1 to 12-12 of the Financial Sector Act of 5 April 1993 (the Financial Sector Act). These articles were introduced by the Act of 21 November 1997 for banks issuing mortgage bonds and amended by the Act of 22 June 2000, by the Act of 24 October 2008 and by the Act of 27 June 2013. The Lettres de Gage regulations are supplemented by the *Commission de Surveillance du Secteur Financier* (CSSF) Circular 01/42 which lays down the rules for the appraisal of real estate and CSSF Circular 03/95 which defines the minimum requirements for the maintenance and control of the cover register, for the cover assets and for the issuance limit for outstanding Lettres de Gage. The CSSF is the supervisory authority in Luxembourg.

The amendments introduced in June 2013 included: (i) a broadening of the geographical scope to assets acquired globally but with certain rating requirements for countries outside the European Union (EU), the European Economic Area (EEA) and the Organisation for Economic Co-operation and Development (OECD); (ii) the introduction of Lettres de Gage Mutuelles which are backed by a system of institutional guarantee; (iii) change of the rating requirements of eligible securitisations which now refer to the list of rating agencies established by the European Securities and Markets Authority (ESMA) rather than S&P, Moody's and Fitch; (iv) an explicit definition of public enterprise; (v) a clarification that the cover assets have to be the property of the bank and (vi) a legal obligation for the issuers to publish information on the cover pools, the lettres de gage and the issuers.

The bankruptcy regulations have also been completely revised. If the court declares open one of the procedures provided for in the law on the financial sector, i.e. suspension of payments or compulsory liquidation, this decision entails the separation of the bank into the cover pools and additional activities. The cover pools with their corresponding bonds and their corresponding reserve with the central bank continue as proprietary compartments of a mortgage bank with limited activity. This bank still holds a banking licence. The court can also open a procedure of suspension of payments or compulsory liquidation for a cover pool, but this does not affect the other cover pools.

The CSSF is no longer administrator of cover pools in the case of bankruptcy of the Lettres de Gage bank but one or several administrators nominated by the court.

II. STRUCTURE OF THE ISSUER

The Lettres de Gage issuers have to be credit institutions with a specialist bank licence. Their business activities are restricted: In the past, the bank's principal activities were limited to mortgage lending, public sector financing, and lending guaranteed by movable assets which were primarily funded by issuing Lettres de Gage Hypothécaires, Lettres de Gage Publiques and Lettres de Gage Mobilières. Lettres de gage Mobilières were introduced in the amendment in October 2008. According to the last covered bond law amendments in 2013, the Luxembourg issuers are also allowed to issue Lettres de Gage backed by institutional guarantees (Lettres de Gage Mutuelles). They can grant loans to credit institutions in the EU, the EEA and the OECD or loans that are guaranteed by them, on the condition that these credit institutions belong to a system of institutional guarantee. This system has to be recognised by a supervisory authority and guarantee to support its members in the case of economic difficulties.

The issuers may only engage in other banking and financial activities if these activities are accessory and auxiliary to their main business.

The issuer holds the cover assets on its balance sheet in separate registers. Each class of Lettres de Gage has its own register: one for assets which are allocated to the Lettres de Gage Hypothécaires, another one for the cover assets backing the Lettres de Gage Publiques, potentially several more for the various forms of Lettres de Gage Mobilières and one for the cover assets backing Lettres de Gage Mutuelles. The cover assets remain on the balance sheet of the issuer. They are not transferred to another legal entity (special purpose vehicle) like in a securitisation. All obligations arising from Lettres de Gage are direct, unconditional obligations of the issuer. In the case of issuer insolvency, the cover pools are segregated by law from the general insolvency estate and are reserved for the claims of the Lettres de Gage holders. There is no direct legal link between a single asset in the cover pool and an outstanding Lettre de Gage. Interest and principal payments of the outstanding Lettres de Gage Hypothécaires, Lettres de Gage Publiques, the various forms of Lettres de Gage Mobilières (including any derivatives benefiting from the preferential treatment) and the Lettres de Gage Mutuelles are backed by the assets in the respective cover pools.

Lettres de Gage issuers employ their own staff. The issuers have to be banks and according to the Financial Sector Act they need to have sound administrative and accounting procedures, control and safeguard arrangements for electronic data processing and adequate internal control mechanisms which restrict the extent of outsourcing legally possible. In addition, the way of permitted outsourcing is described in detail in different CSSF Circulars.

III. COVER ASSETS

The eligible cover pool assets are defined in Article 12-1 of the Financial Sector Act of 5 April 1993. Since the amendments of the covered bond legislation in June 2013, there are four asset classes: mortgage assets, public sector exposures, movable assets, i.e. mortgage loans on ships, aircrafts, trains or other classes of movable assets, and assets backed by a system of institutional guarantee. There is only one regional limitation in place. Credit institutions that are members of a system of institutional guarantee have to be established in a member state of the EU, the EEA or the OECD. For all other cover assets the restriction to this region has been abolished. In return, a criterion regarding the credit quality of the assets has been introduced. The respective cover pools can contain 50% assets from outside the EU, the EEA and the OECD, if a rating agency registered on the list at ESMA grants a rating of the first credit quality step to these assets, and 10%, if the rating is of the second credit quality step.

In each of the various cover pools the assets may be replaced by up to 20 % of the nominal value of the outstanding Lettres de Gage by substitution assets, for example cash, assets with central banks or with credit institutions or bonds satisfying the conditions set out in Article 43 (4) of the law of 17 December 2010 concerning undertakings for collective investments.

It is also possible to hold the cover assets indirectly through a third-party bank.

The Lettres de Gage Mobilières are backed by movable assets, i.e. mortgage loans on ships, aircrafts, trains or other classes of movable assets. In order to be cover pool eligible, the movable assets and the charges on the property of those assets need to be registered in a public register.

In addition, securitised assets are cover pool eligible if they comply with the eligibility criteria laid down for the various types of Lettres de Gage. The amount of securitised assets that are not cover pool eligible per se will be limited to 10% of the collateral pool. This can be achieved in two ways: One option would be that at least 90% of the assets of each securitisation (vehicle) are cover pool eligible. The other option would be that at least 50% of the assets of each securitisation (vehicle) are cover pool eligible. In that case, the percentage of securitisation assets shall not exceed 20% of the total collateral pool. The issuer can choose one of the two options for each type of Lettre de Gage but cannot combine the two options. Moreover, the securitisation tranches should have a rating of the first credit quality step by a rating agency that is registered on the list by ESMA. The law allows only true sale transactions and synthetic securitisations are explicitly excluded.

Any kind of obligation from public sector institutions including public private partnerships (providing a controlling public sector stake; other public private partnership structures are subject to the above mentioned 10% limit) are cover pool eligible.

There is no limitation on the volume and the types of derivatives used as long as they are employed as hedging instruments.

The cover pools are dynamic. Assets can be included, excluded and exchanged as long as the requirements of the law are not breached.

There is an explicit transparency requirement. The issuers have to publish information on the composition of the cover pool, the bonds and the issuers. The details of which are defined by the CSSF.

IV. VALUATION AND LTV CRITERIA

The property valuation methods are defined by a CSSF Circular 01/42 and are based on the mortgage lending value of the property. A special auditor, who may not simultaneously hold the position of company auditor, has the responsibility of determining whether the property valuation has been undertaken according to the valuation rules.

The LTV limit for residential property is 80% of the estimated realisation value. The LTV ratio is 60% for all other immovable and movable properties including commercial real estate loans. The actual loan, however, can exceed the 60% limit (or 80% limit in case of residential mortgages). In those cases, only the first 60% (80%, respectively) of the mortgage lending value is eligible for the cover pool.

V. ASSET – LIABILITY MANAGEMENT

There is a minimum overcollateralisation level of 2% on a nominal basis as well as on a net present value basis. The Luxembourg regulator has the right to review and adjust these overcollateralisation levels. Any mismatches in terms of currency or interest rate risk have to be hedged and the respective hedge instruments have to be included in the collateral pool. In addition, there are the requirements imposed by the rating agencies.

The special auditor has to ensure that there is always sufficient collateral in the pool. This has to be certified by the special auditor when Lettres de Gage are issued. Cover assets may only be removed from the cover pool when the prior written consent of the special auditor has been received and provided that the remaining cover assets are sufficient to guarantee the legally protected cover.

The calculation of the nominal value and of the net present value of the collateral pool as well of the outstanding Lettres de Gage volume must be reported to the supervisory authority on a monthly basis.

VI. TRANSPARENCY

There is an explicit transparency requirement. The issuers have to publish information on the composition of the cover pool, the lettres de gage and the issuer. The details of which will be defined by the CSSF. This is in line with the ECBC Covered Bond Label Initiative.

VII. COVER POOL MONITOR AND BANKING SUPERVISION

The supervisory authority of covered bond issuers is the CSSF, as already mentioned above. The CSSF has a specialised department which is responsible for supervising the Lettres de Gage issuers. It is entitled to demand relevant reports and intercede if liquidity problems have been identified at a bank.

The CSSF is also responsible for the approval of the various types of covered bonds secured by movable assets. Definitions, the details on which types of movable assets qualify and other practical issues will be clarified in a separate CSSF Circular.

For the independent control of the cover pool a special auditor which is recommended by the Lettres de Gage issuer has to be approved by the supervisory authority. Only auditing firms which satisfy the conditions set forth in the law of 2009 regarding *réviseurs d'entreprises* (independent auditors) can be appointed as special auditors. The issuer communicates the names of the partners of these auditing firms who will fulfil the function to CSSF. The special auditor must have a suitable qualification and must be able to call upon the experience and technical expertise of a recognised international auditing firm.

The special auditor is continuously responsible for monitoring the collateral pool and the outstanding Lettres de Gage. The auditor must ensure that there are sufficient assets in the collateral pool to service the obligations resulting from the outstanding Lettres de Gage up to the final maturity of the last outstanding bond. The auditor is obliged to inform the supervisory authority immediately, should any of the prudential limits be violated. The Lettres de Gage issuer is also obliged to immediately inform the supervisory authority of the violation of any limits.

Rating agencies do not play any mandatory role in the monitoring process. The issuers comply with the rating agencies' requirements on a voluntary basis.

VIII. SEGREGATION OF COVER ASSETS AND BANKRUPTCY REMOTENESS OF COVERED BONDS

The cover registers for mortgage, public sector and moveable assets and assets backed by a system of institutional guarantee include all necessary data to identify the assets and the derivatives included. As soon as an asset or derivative product is registered in the official cover register it forms part of the collateral pool.

The cover register is managed by the issuer but regularly monitored by the special auditor. The special auditor is obliged to inform the CSSF of any irregularities and provide an annual report.

Asset segregation

In the case that a procedure of suspension of payments or compulsory liquidation is opened for a Lettres de Gage issuer, the assets and derivatives in the collateral pool are separated from the other assets and liabilities of the bank. The respective collateral pools remain unchanged and continue with their corresponding Lettres de Gage and their corresponding reserve at the Luxembourgish Central Bank as proprietary compartments of a Lettres de Gage bank with limited activity. The cover pools do not become separate legal entities. The legal entity of the bank remains unchanged. The banking license continues for the bank with limited activity in order to achieve the purpose of administering the cover pool up to the final maturity of the last outstanding Lettre de Gage. The court nominates one or several administrators for the cover pools. This administrator is different from the general bankruptcy administrator. If a procedure of suspension of payments or compulsory liquidation is opened for one cover pool, the other pools are not affected by this decision and continue.

Impact of insolvency proceedings on Lettres de Gage and derivatives

Lettres de Gage do not automatically become due when a procedure of suspension of payments or compulsory liquidation is opened for the issuing bank. Interest and principal are paid as per their original due dates. The same applies to derivatives registered in the cover register which are part of the cover pool. The net present value of the derivatives after netting ranks pari passu with the claims of the Lettres de Gage holders.

Preferential treatment of covered bond holders

Lettres de Gage holders benefit from a preferential treatment in case of an issuer insolvency. The registration of the cover assets in the cover register provides the Lettres de Gage holders with a preferential right, above all other rights, preferences and priorities of any nature whatsoever, including those of the Treasury. But the salary of the administrator and the other fees that are necessary for continuing the bank with limited activity rank first before the claims of the Lettres de Gage holders and the derivative counterparties, which rank pari passu. The general bankruptcy administrator has no direct access to the assets in the collateral pool.

Access to liquidity in case of insolvency

The administrator nominated by the court administers the cash flows resulting from the cover assets and according to the Article 12-10 (5). The administrator can issue lettres de gage for the account of the lettres de gage bank with limited activity. He or she can approach the Luxembourgish Central Bank for liquidity, where the conditions to be fulfilled as a counterparty for transactions within the framework of monetary politics depend on the Eurosystem.

The administrator can transfer the administration of the cover assets and the Lettres de Gage to another bank.

There is no explicit provision in the law regarding any voluntary overcollateralisation. But the overcollateralisation in a cover pool serves to pay for the expenses for the continuation of the bank with limited activity as well as absorb losses.

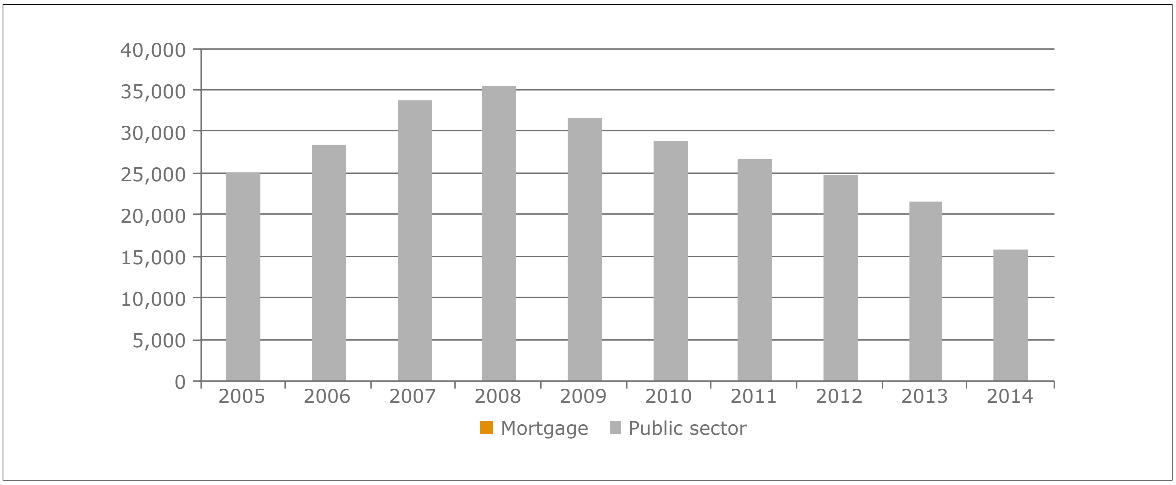
IX. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

The Luxembourgish covered bond legislation fulfils the criteria of Article 52 (4) of the UCITS Directive (Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS)). In its current format, the Lettres de Gage legislation does not fulfil the requirements set out in Article 129 of Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012, the Capital Requirements Regulation (CRR), together with Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC, the Capital Requirements Directive (CRD), implementing the Basel III rules into European law.[1] The last two amendments of the Luxembourg covered bond legislation did not make the Lettres de Gage legislation CRR-compliant. However, it should be possible for issuers to make their outstanding Lettres de Gage "CRR compliant" by limiting their cover pool exposure.

Lettres de Gage are principally eligible for repo transactions with the European Central Bank (ECB). However, on 28 November 2012, the ECB announced amendments of its eligibility criteria for its repo transactions. The changes entered into force on 3 January 2013. Covered bonds with external, non-intra group securitisations in the cover pool are no longer eligible as collateral for repo transactions as of 31 March 2013. To smooth the impact for existing programmes, the ECB granted a grandfathering period of two years until 28 November 2014 for already issued covered bonds. This means that new covered bonds with external RMBS or other ABS (both group-internal or external) in the cover pool are no longer repo eligible from the end of March 2013 although tap issues of grandfathered covered bonds will remain eligible during the grandfathering period, as long as no additional external RMBS or other ABS are added to the cover pool.

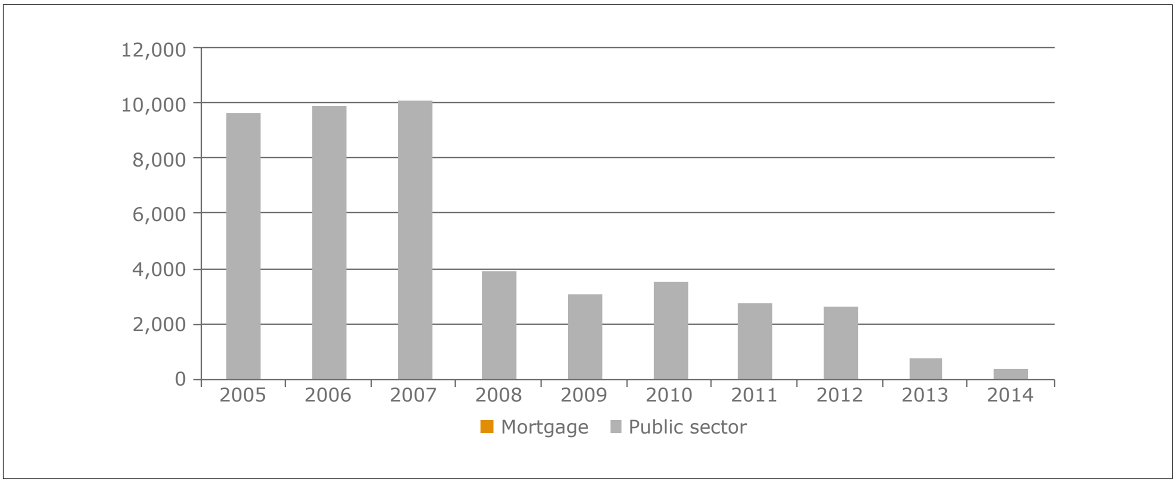
[1] Please click on the following link for further information on the UCITS Directive and the CRR: http://ecbc.hypo.org/Content/default.asp?PageID=504#position.

> Figure 1: Covered Bonds Outstanding, 2005-2014, EUR m



Source: EMF-ECBC

> Figure 2: Covered Bonds Issuance, 2005-2014, EUR m



Source: EMF-ECBC

Issuers: Dexia LdG Banque, Erste Europäische Pfandbrief- und Kommunalkreditbank, Hypo Pfandbrief Bank International, Hypothekenbank Frankfurt International,NORD/LB Luxembourg Covered Bond Bank, Société Générale Lettres de Gage.

ECBC Covered Bond Comparative Database:
http://www.ecbc.eu/framework/84/Lettres_de_Gage_publiques,
http://www.ecbc.eu/framework/85/Lettres_de_Gage_hypoth%C3%A9caires,
http://www.ecbc.eu/framework/86/Lettres_de_Gage_mobili%C3%A8res, and
http://www.ecbc.eu/framework/105/Lettres_de_Gage_mutuelles.

3.20 THE NETHERLANDS

By Arjan Scheltema, NautaDutilh, Robert Masman, Clifford Chance,
Thijs Naeije, ABN AMRO Bank N.V and Frans Huijbers, DACB

I. DUTCH COVERED BOND FRAMEWORK

New legislation

The Dutch legislative framework for regulated covered bonds is incorporated in:

> the Dutch Financial Supervision Act *(Wet op het financieel toezicht)*;

> the Decree on Prudential Rules Wft *(Besluit prudentiële regels Wft)*; and

> the Implementing Regulation Wft *(Uitvoeringsregeling Wft)* (together the 'CB Legislation').

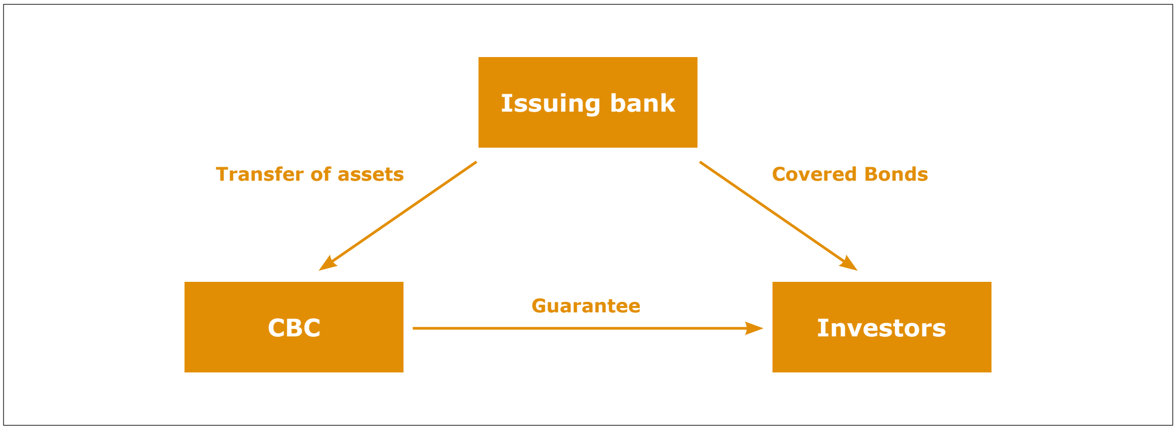
The CB Legislation replaces the Dutch covered bond regulations introduced in 2008 (the '2008 Regulations'). The aim of the CB Legislation is to strengthen regulatory supervision on regulated covered bonds by the Dutch Central Bank (*De Nederlandsche Bank* (DNB)), to increase investor confidence and to lower financing costs of Dutch banks.

The CB Legislation incorporates new (international) market standards, including the best practices identified by the European Banking Authority (EBA) in its report "EBA Report on EU Covered Bond Frameworks and Capital Treatment" of 1 July 2014, and certain contractual and structural features of existing Dutch covered bond programmes. Although the CB Legislation contains a number of additional registration requirements focusing on, amongst other things, transparency, cover asset quantity and quality and stress testing, the CB Legislation does not substantially amend the requirements under the 2008 Regulations relating to asset segregation, risk management, asset encumbrance safeguards and reporting to DNB.

Structure of Dutch covered bonds

The CB Legislation prescribes a so-called "segregated" structure, being a structure where the cover assets are segregated from the issuer and owned by a special purpose company (the 'CBC'), which is separate from, and not affiliated to, the issuer. Asset segregation takes place on the basis of the Dutch Civil Code and the Dutch Bankruptcy Code. The CB Legislation only relates to the issuance of covered bonds by Dutch banks. Dutch rules related to investing in covered bonds by Dutch regulated entities are dealt with in other regulations, directives and rules.

> FIGURE 1: SEGREGATED STRUCTURE – DUTCH COVERED BONDS



Regulated covered bonds (as defined below) are issued by a licensed bank and are guaranteed by the CBC owning the cover assets, thus creating dual recourse for the covered bondholders. An insolvency of the issuer does not in itself result in an insolvency of the CBC. The CBC is a special purpose vehicle set up as a bankruptcy-remote entity, as follows. It is a private company with limited liability *(besloten vennootschap met beperkte aansprakelijkheid)* wholly owned by an orphan foundation *(stichting)*, with independent directors provided by a corporate services provider. The CBC does not have employees. It has limited corporate objectives clause to ensure that it does not conduct business other than envisaged by the transaction documents. Non-petition and limited recourse wording is agreed with all transaction parties that are creditors of the CBC under the transaction documents. Any remaining third party creditors not signing up to such non-petition and limited recourse provisions are listed high in the relevant priority of payments, so as to ensure they are paid in priority and timely.

The CBC pledges the cover assets to a security trustee, which is an orphan foundation especially established to act as a security trustee in relation to the relevant DNB-registered covered bonds. The security trustee holds the rights of pledge in its own name, but acts in the interest of the covered bondholders and certain other transaction parties that are creditors of the CBC. The pledge by the CBC to the security trustee is not required pursuant to the CB Legislation, however is standard practise.

Conditions for registration with the Dutch Central Bank

A Dutch covered bond registered under the CB Legislation by DNB complies with the conditions for preferential treatment as set out in Article 52(4) of the UCITS Directive and Article 129 of the Capital Requirements Regulation (CRR) (‘regulated covered bonds’). A regulated covered bond is therefore eligible for receiving favorable treatment under the monetary policy operations of the European Central Bank. DNB will record in its covered bonds register whether the relevant category of covered bonds (continues to) comply with Article 129 CRR. The register is available online and can be found at: www.dnb.nl/en/supervision/consumer-and-supervision/registers/WFTGO.

With respect to the registration of both the covered bonds and the issuer, the following requirements need to be fulfilled:

- the issuer is a bank having its registered office in the Netherlands (that excludes non-bank subsidiaries and banks operating in the Netherlands on a cross-border basis or through a branch office), which falls under the supervision of the Dutch Central Bank and as such must fulfil all regulatory requirements with regard to, *inter alia*, solvency, liquidity and business operations;
- the cover assets provide sufficient cover for the payment of principal and interest on the covered bonds and costs relating to risk management and the management and administration of the cover assets and covered bonds;
- the cover assets have been safeguarded for the benefit of the covered bondholders by way of a transfer to a CBC;
- the issuer or its group do not own or control the CBC and the CBC must be a remote special purpose vehicle specifically set up for one category of covered bonds (i.e. one programme);
- disclosure by the issuer to DNB of certain key conditions applicable to the relevant category of covered bonds, which include:
  - whether the covered bond has one of the following maturity structures: (i) its maturity date cannot be extended (hard bullet maturity), (ii) its maturity date can be extended for a maximum of 24 months (soft bullet maturity) or (iii) its maturity date can be extended with more than 24 months (e.g. conditional pass through);

  - which type or types of cover assets can without any limitation be included in the cover pool (so called primary cover assets) and if more than one type of cover assets is included, the ratio between the types of cover assets used; and
  - the jurisdiction in which the debtors of the cover assets are located and the governing law of the cover assets.
- the issuer must ensure that a healthy ratio exists between the total amount of outstanding covered bonds of the relevant category and the total consolidated balance sheet of the issuer; and
- the issuer must have reliable and effective strategies and procedures in place to make sure the CBC holds sufficient eligible cover assets and liquid assets, the meet the minimum required statutory limits for over-collateralisation, liquidity buffer requirements and other applicable asset cover requirements.

A minimum credit rating for regulated covered bonds – as required under the 2008 Regulations – is no longer a requirement under the new CB Legislation.

II. COVER ASSETS

Primary cover assets

Currently, under the CB Legislation the following assets can be used as primary cover assets for the cover pool of a regulated covered bond:

- public sector (guaranteed) exposures as referred to in article 129 CRR, paragraph 1(a) and (b) (excluding credit quality step 2 exposures);
- residential mortgage loans or guaranteed residential loans as referred to in article 129 CRR, paragraph 1(d)(i) and (e) respectively;
- commercial mortgage loans as referred to in article 129 CRR, paragraph 1(f)(i); or
- shipping loans as referred to in article 129 CRR, paragraph 1(g).

An issuing bank may use only one category of cover assets as primary cover assets, except for residential mortgage loans and commercial mortgage loans, which can be combined as primary cover assets provided that the ratio between these categories is fixed as from the date of registration.

Substitution assets

The CB Legislation permits the inclusion of substitution assets in the relevant cover pool provided that the substitution assets do not exceed 20% of the nominal amount of the outstanding regulated covered bonds. Substitution assets must either be public sector (guaranteed) exposures as referred to in Article 129 CRR, paragraph 1(a) or (b), exposures to institutions as referred to in Article 129 CRR, paragraph 1(c) or credit quality step 2 exposures permitted by DNB as referred to in Article 129 CRR, paragraph 1, third sub-paragraph, and are further subject to the restrictions of Article 129 CRR.

III. VALUATION AND LTV CRITERIA

When residential mortgage loans are used as cover assets, the CRR prescribes that these loans should be valued only up to the lesser of:

- the principal amount of the relevant mortgage loan; and
- 80% of the value of the underlying mortgaged property.

In the Netherlands a loan-to-value (LTV) limit has been introduced for newly originated mortgage loans. This maximum LTV limit is referred to as the ‘Eligibility Percentage’ and has been set at 103% for residential mortgage loans originated in 2015. This upper limit for newly originated mortgage laons will decrease annually with 1%, until 2018 when the limit will be fixed at 100%.

With respect to LTV, Dutch covered bond programmes take a two-step approach when using Dutch residential mortgage loans as cover assets:

> subject to certain exceptions in some programmes, loans are only eligible when the LTV-ratio does not exceed the Eligibility Percentage (103% in 2015); and

> once a loan forms part of the cover assets of the CBC, the maximum value attributed to it in the asset cover test is a certain percentage (the 'LTV Cut-Off Percentage') of the value of the underlying mortgaged property at such time. For example, if:

> > the relevant LTV Cut-Off Percentage is 80%; and

> > a loan has a principal amount of 103 and is backed by mortgaged property with a value of 100, then such loan would be valued at no more than 80 in the asset cover test.

The 23 excess value of the loan serves as an additional credit enhancement for investors in Dutch covered bonds.

Like the CRR, the Dutch CB Legislation does not prescribe whether the foreclosure value or the market value of the underlying mortgaged property should be taken into account when calculating the LTV ratio. To date under the Dutch covered bond programmes both the eligibility percentage and the LTV cut-off percentage are applied to the market value. The way in which the market value is calculated differs from programme to programme.

IV. ASSET – LIABILITY MANAGEMENT

All Dutch covered bond programmes contain contractual asset cover tests which ensure that (a) assets transferred to the CBC will be sufficient to make all interest and principal payments on the covered bonds in case of a default by the issuer and (b) the credit ratings assigned to the covered bonds can be maintained. The CB Legislation in addition contains two mandatory asset cover tests and a liquidity test which will apply to Dutch regulated covered bond programme.

Mandatory asset cover tests and over-collaterisation

The CB Legislation contains two mandatory asset cover tests. Firstly, the total value of the cover assets must be at least 105% of the nominal value of the outstanding regulated covered bonds. In addition to this the total value of the cover assets, as determined in accordance with the restrictions applicable to the relevant type of assets as set out in Article 129 CRR, paragraph 1 should at least be equal to the nominal value of the outstanding regulated covered bonds (100%). When calculating these two minimum required over-collateralisation ratios the nominal value will be used (subject to certain deductions, see next sub-paragraph) for the primary cover assets, whilst for the substitution assets the market value will be used (as determined in accordance with internationally accepted accounting principles).

Defaulted cover assets as referred to in Article 178 CRR, cover assets in respect of which third parties are entitled to (part) of the proceeds thereof (for example, sub-participations), and cover assets which represent exposures to the relevant issuing bank or its group companies must be deducted when determining the value of the cover assets.

Mandatory liquidity buffer

The CB Legislation requires the CBC to have (or generate) sufficient liquid assets to cover in the following six month period the payment of: (a) interest, (b) principal (only in respect of regulated covered bonds which are allowed to extend the maturity date with less than six months) and (c) other permitted amounts that are equal or higher ranked (e.g. administrative costs).

For the purpose of calculating the mandatory liquidity buffer, the CBC must also take into account expected cash flows from derivatives and other risk mitigating contracts relating to such payment obligations. Liquid assets may consist of the same type of assets which are permitted as substitution assets (see above).

Covered bond maturity – contractual liquidity

Until September 2013, all DNB-registered covered bond programmes only allowed the issuance of hard and/or soft bullet covered bonds. In September 2013, the first conditional pass-through programme was registered by DNB. Hard/soft bullet and conditional pass-through programmes are discussed separately below.

a. Hard/soft bullet programmes

All hard/soft bullet DNB-registered covered bond programmes require the issuer to establish a reserve fund equal to 3 months' interest payments on the covered bonds plus certain costs and expenses for 3 months if the issuer's credit rating falls below a certain threshold: Fitch: F1 (short-term) and/or A (long-term), Moody's: P1 (short-term) and S&P: A-1 (short-term).

Under all hard/soft bullet DNB-registered covered bond programmes, a total return swap in relation to the cover assets is entered into at inception of the programme. The total return swap swaps the different types of interest received on the cover assets to 1 month's EURIBOR. In addition, an interest rate swap or structured swap is entered into each time a series of covered bonds is issued. The interest rate/structured swap swaps the aforementioned 1 month's EURIBOR/euro's to the interest rate/currency payable under the relevant series of covered bonds.

To mitigate liquidity risk on principal payments, all hard/soft bullet DNB-registered covered bond programmes use either:

> (in the case of hard bullet covered bonds) a pre-maturity test on each business day falling 12 months or less before to the maturity date. The pre-maturity test is failed if on the relevant test date the issuer's short term rating falls below F1+ (Fitch), P-1 (Moody's), A-1 (S&P) or if the long term rating falls below A (S&P). A failure of the pre-maturity test requires (a) the issuer to cash-collateralise the maturing covered bonds or (b) the CBC to put in place alternative remedies such as a guarantee of the issuer's obligations, a liquidity facility and/or a sale or refinancing of cover assets; or

> (in the case of soft bullet covered bonds) a maturity extension (up to a maximum) of 24 months. The possible extension applies only (a) to the CBC after an issuer event of default has occurred and (b) to any final redemption amount payable by the CBC in relation to a series of covered bonds which was not repaid on its scheduled maturity date. In case the CBC has sufficient funds available on an earlier payment date prior to the extended maturity date, these funds will be used to pay (part of) the relevant final redemption amount.

b. Conditional pass-through programmes

The two DNB-registered conditional pass-through covered bond programmes require the issuer to establish a reserve fund equal to a minimum of 3 months' interest payments on the covered bonds plus an additional to cover certain costs. Although the DNB-registered conditional pass-through covered bond programmes allow the use of derivatives if necessary, currently the programmes have not entered into total return swaps or any other derivatives. To prevent the programmes from liquidity shortfalls, the asset cover test tests whether the expected revenues of the cover pool exceed the aggregate remaining interest due on the covered bonds. In case of an expected shortfall, an additional deduction in the asset cover test results in extra over-collateralisation.

To mitigate liquidity risk on principal payments, the conditional pass-through covered bond programme uses maturity extension, once the bonds have turned into pass through mode. A particular series of covered bonds will only turn into pass-through when (1) an issuer event of default has occurred, (2) the series reaches its scheduled maturity date and (3) the available cash combined with the proceeds of a partial sale of the cover pool would not be sufficient to redeem the series in full. However if the amortisation test is breached, all series of covered bonds turn into pass-through.

If a covered bond is in pass-through mode, a sale of cover assets is attempted every six months. During such a six month period all available cash is passed through *pari passu* to the bonds that are in pass through mode. If the proceeds of a sale of cover assets would not be sufficient to redeem the covered bond in full, this six month extension cycle is repeated, with a maximum extension until the maturity of the last maturing cover assets.

V. INVESTOR REPORTING AND SUPERVISION

The Dutch issuers of DNB-registered covered bonds use a Dutch national transparency template, in order to harmonise reporting to investors. In the national transparency template extensive information about both the issued covered bonds and the cover pool can be found. The Dutch national transparency template is compliant with the guidelines of the ECBC's Covered Bond Label initiative and can be found on the website of the Covered Bond Label (www.coveredbondlabel.com). The investors reports can be found on the relevant issuer's website. Links to these pages are also available on the website of the DACB (www.dacb.nl).

Once a Dutch covered bond programme is registered by DNB, the issuer will have ongoing administration and reporting obligations towards investors and DNB.

Towards investors Dutch issuers are required to provide information at least on a quarterly basis, which includes – but is not limited to – information with respect to:

> credit risks, market risks, exchange rate risks and liquidity risks;

> nominal value and maturity of the regulated covered bonds issued;

> the value and composition of the underlying cover assets and liquid assets;

> the actual percentage of over-collateralisation and size of the liquidity buffer; and

> the percentage of defaulted cover assets.

Dutch issuers also have ongoing administration and reporting obligations towards DNB, including that they must:

> demonstrate at least quarterly that the regulated covered bonds continue to meet the criteria summarised in paragraphs I *(Framework)*, II *(Cover assets)* and IV *(Asset – Liability Management)*;

> demonstrate at least annually to DNB that it has reliable and effective strategies and procedures in place for verifying and procuring the sufficiency of eligible cover assets and liquid assets;

> submit to DNB annually, within six months of the close of its financial year, the annual financial statements and the annual report of the CBC;

> submit to DNB at least annually, information on the required healthy ratio as referred to in paragraph I *(Framework)*;

> notify DNB of significant changes it intends to make in the conditions of the regulated covered bonds prior to implementation thereof; and

> provide DNB with all information with respect to the regulated covered bonds DNB deems relevant to be able to exercise its supervision.

The issuer must furthermore:

> ensure on a continuing basis that the conditions applicable to the regulated covered bonds contain no impediments to an effective supervision of DNB;

> carry out on a regular basis stress test to ensure that in times of financial stress the required healthy ratio referred to in paragraph I *(Framework)* is maintained;

> ensure that an external accountant is appointed which is required to perform at least annually an audit on the cover assets to verify whether the calculations for the abovementioned asset cover tests and

mandatory liquidity buffer have been made correctly (the agreement between the accountant and the issuing bank must be such that the accountant will continue to perform these services post default of the issuing bank);

> ensure that in a pre-issuer default scenario, an external accountant shall at least annually perform an audit on a sample of cover assets focusing on the recorded valuation of such cover assets and the administration thereof; and

> submit to DNB copies of reports of auditors in relation to the abovementioned audits.

The above is without prejudice to the general authority of DNB to request information from the issuer on the basis of its regular banking supervision powers.

No deregistration of regulated covered bonds

If regulated covered bonds no longer meet the requirements set by the CB Legislation and the issuing bank no longer complies with its ongoing administration and reporting obligations towards DNB, the DNB could impose sanctions on an issuer. Possible sanctions include: an issuance-stop (which may be disclosed by DNB in its register) and penalties and fines. Contrary to its powers under the 2008 Regulations, DNB is however not entitled to cancel the registration of a regulated covered bond. DNB is only entitled to cancel the registration of the issuing bank. In case the regulated covered bonds are no longer collateralised by assets that comply with the requirements set out in Article 129 CRR, DNB may delete the registration of compliance with Article 129 CRR resulting in a situation where such regulated covered bonds will be solely UCITS-compliant.

Grandfathering

The CB Legislation grants issuers of registered covered bonds, and issuers that have applied for registration, under the 2008 Regulations a transitional period of twelve months from 1 January 2015 for its covered bonds to comply with the new requirements prescribed by the CB Legislation. Such issuers must during such transitional period comply with the requirements prescribed by the 2008 Regulations. As from 1 January 2016 the CB Legislation applies to all registered Dutch covered bond issuers and their covered bond programmes.

VI. ADDITIONAL INFORMATION

More information on the DACB and its members can be found at www.dacb.nl.

The Dutch Association of Covered Bond Issuers (DACB) was established on 7 January 2011. The main goal of the DACB is to represent the Dutch issuers of covered bonds and to act as a platform for the exchange of information among its members. The DACB's key objectives are to:

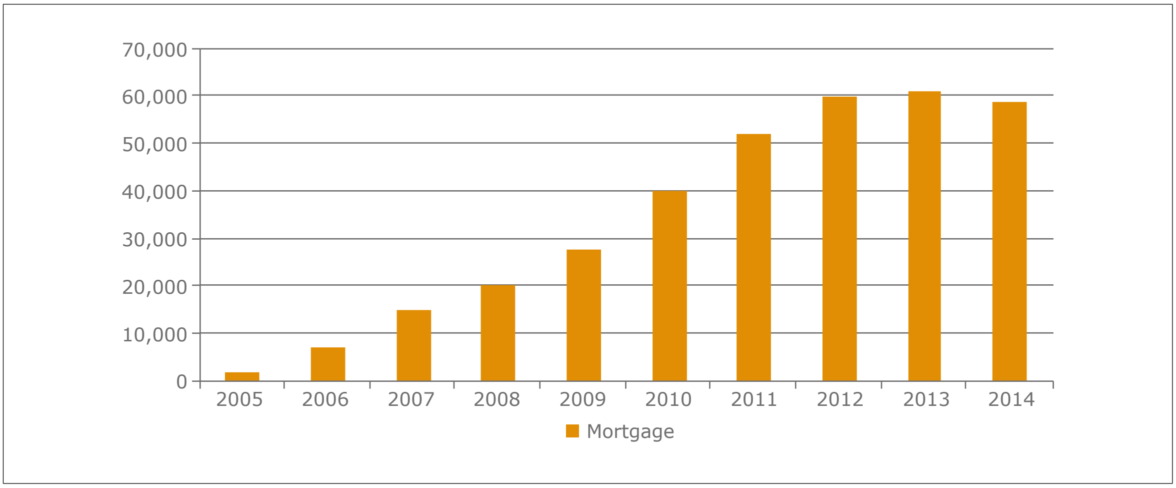
> Represent the interests of the Dutch issuers in discussions with legislative and regulatory authorities;

> Provide investors with information about the Dutch covered bond market;

> Participate on behalf of the Dutch issuers in international covered bond organisations like the ECBC; and

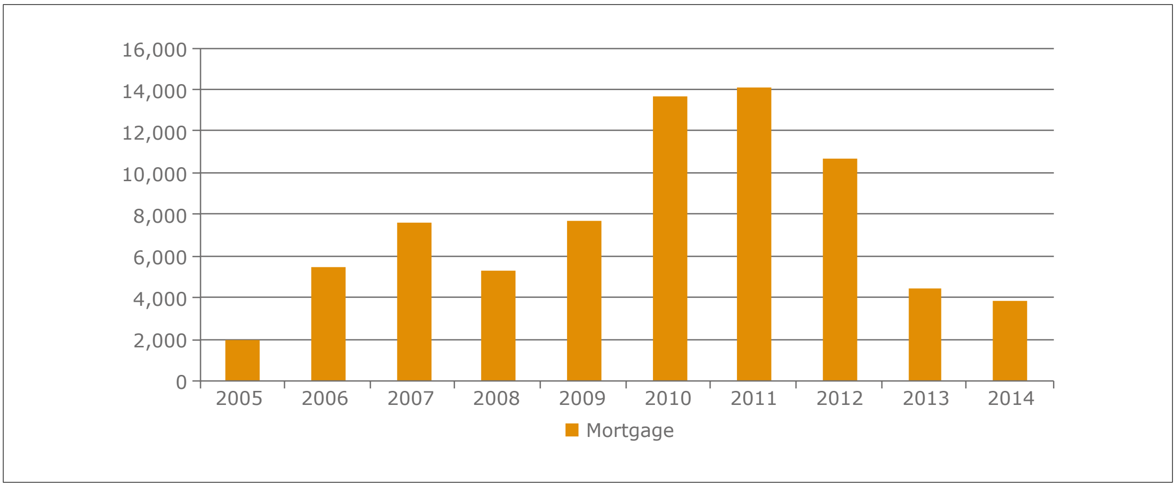
> Continuously improve the quality of the Dutch covered bond product offering.

> Figure 1: Covered Bonds Outstanding, 2005-2014, EUR m



Source: EMF-ECBC

> Figure 2: Covered Bonds Issuance, 2005-2014, EUR m



Source: EMF-ECBC

Issuers: Currently, five DNB-registered covered bond programmes exist in the Netherlands: the covered bond programmes of ABN AMRO Bank N.V., F. Van Lanschot Bankiers N.V., ING Bank N.V., SNS Bank N.V. and NIBC Bank N.V.

ECBC Covered Bond Comparative Database: http://www.ecbc.eu/framework/65/Dutch_registered_CBs_programmes.

Covered Bond Label: ABN AMRO Cover Pool; ING Bank; SNS Cover Pool; NIBC Conditional Pass-Through Covered Bond Programme; F. van Lanschot Bankiers NV CPTCB Programme.

3.21 NEW ZEALAND

By Frank Will, HSBC & Chairman of the ECBC EU Legislation Working Group

SUMMARY

The first covered bond was issued out of New Zealand in June 2010. At that time, New Zealand did not have a legislative covered bond framework and the domestic issuers used the well-tested general law-based covered bond approach following in the footsteps of the UK, France, and Canada. Since then, the regulatory authorities in New Zealand have developed dedicated covered bond legislation to support further growth of this market segment. In May 2012, the Minister of Finance introduced the Reserve Bank of New Zealand (Covered Bonds) Amendment Bill (Amendment Bill) into Parliament. Following a lengthy consultation process with the House of Representatives, the law on covered bonds came into force in December 2013, by virtue of the Reserve Bank of New Zealand (Covered Bonds) Amendment Act 2013.

Since the amendment act has come into effect and following a 9-month transition period, banks are only allowed to issue covered bonds under registered programmes. During the transition period, all issuers registered their covered bond programmes that existed before the legislation came into effect with the Reserve Bank of New Zealand. Once the programmes were registered, covered bonds issues under the programmes prior to registration also received the benefits of the new legislation.

I. FRAMEWORK

No covered bond regulation was in place in June 2010 when New Zealand covered bonds were first issued and issuance of covered bonds was neither prohibited nor limited by any prudential requirements or other regulation.

In October 2010, the central bank released a consultation paper on proposals for a regulatory framework to provide additional certainty to investors, and to improve the disclosure requirements in order to support the development of the covered bond market in New Zealand.

In January 2011, the Reserve Bank of New Zealand (RBNZ) introduced a regulatory issuance limit for the issuance of covered bonds by New Zealand banks (which came into force in April 2011). The regulation limits the value of assets encumbered for the benefit of covered bondholders to 10% of total assets of the issuing bank. At that time the RBNZ said that this was an initial limit and that its appropriateness would be reviewed by the Central Bank, taking into account the developments within the covered bond market in New Zealand.

In December 2011, the RBNZ conducted another public consultation. The final paper was in essence aligned with the earlier consultation paper. Following approval by Cabinet in April 2012, the Reserve Bank released a Cabinet paper and Regulatory Impact Statement confirming policy positions relating to the matters discussed in the Reserve Bank’s December 2011 consultation paper on covered bonds.

In May 2012, the first reading on the Amendment Bill took place. Following its first reading, the Bill was referred to the Finance and Expenditure Select Committee. In February 2013 the second reading took place. Following a third and final reading, the Amendment Bill was passed by the Parliament and received Royal Assent in December 2013. It came into force on 10 December 2013.

The New Zealand covered bond legislation gave existing covered bond issuers nine months to register their covered bond programme with the RBNZ. Each issuance under the programme is also proposed to be registered with the RBNZ. All NZ issuers have registered their old programmes which means that all outstanding NZ covered bonds receive now the benefit of the legislation.

II. STRUCTURE OF THE ISSUER

As of June 2015, issuers from five New Zealand banking groups have issued covered bonds, being ANZ Bank New Zealand Limited (ANZ), ASB Bank Limited (ASB), Bank of New Zealand (BNZ), Westpac New Zealand Limited (Westpac) and Kiwibank Limited (Kiwibank). With the exemption of Kiwibank, all issuers are ultimately owned by Australian parent banks. However, the Australian parent companies ANZ, CBA, NAB and Westpac do not guarantee the covered bonds. Typically, NZD denominated bonds have been issued directly by the New Zealand banks, while non-NZD bonds have been issued through the London branches of their respective subsidiaries and are guaranteed by the New Zealand parent company. The RBNZ emphasised from the outset that it is supportive of the covered bond product. Banks can issue bonds backed by a dynamic pool of assets, and the covered bonds rank pari-passu to each other. The covered bonds are irrevocably guaranteed by the covered bond guarantor (CB guarantor) under the covered bond guarantee. The CB guarantor will only make payments under the bonds when (a) an issuer event of default has occurred, and a notice to pay is served on the CB guarantor or, (b) a CB guarantor event of default has occurred and a covered bond guarantee acceleration notice is served on the CB guarantor and the issuer.

Under the covered bond law, issuers are required to register their programmes with the RBNZ.

III. COVER ASSETS

The new covered bond law does not restrict the type of cover assets. The Reserve Bank stated on its website that the assets eligible to be included in the cover pool do not need to be prescribed by legislation because banks specify asset eligibility in programme documentation. In the Reserve Bank’s opinion, legislative restrictions on cover pool assets may unnecessarily restrict an issuer’s ability to develop covered bond programmes.

The existing covered bond programmes are backed by a dynamic pool of residential mortgage loans originated in New Zealand. The common eligibility criteria for these mortgage loans across the programmes are listed below:

> Denominated and repayable only in New Zealand Dollars (NZD);

> Secured by first ranking residential mortgages in New Zealand;

> Mortgage loans with a term not exceeding 30 years;

> Outstanding principal balance of no more than NZD 1.5 m (Westpac)/NZD 2.0 m (ANZ, ASB, Kiwibank)/ NZD 2.5 m (BNZ); and,

> Not in arrears/have not been in default for more than 30 days.

Some of the issuers have additional features beyond these requirements. Moreover, issuers are also allowed to hold liquid substitution assets. These assets, are subject to an overall limit of 10%-20% of the cover portfolio depending on the issuer (Westpac 20%, BNZ 15%, ANZ, ASB and Kiwibank 10%), with the exception of cash that has no limit.

IV. VALUATION AND LTV CRITERIA

In New Zealand, every property is typically valued during the underwriting process. All five existing covered bond programmes do not restrict the LTV limit for mortgage loans in the cover pool. However, in the case of ASB and Westpac, the Asset Coverage Test (ACT) caps the valuation of the property at 75%. In case of ANZ, BNZ and Kiwibank this cap is set at 80%. In effect, this means the maximum amount of a loan that can count in the ACT test is 75% or 80% of the property value respectively.

V. ASSET-LIABILITY MANAGEMENT

Issuance limit: As mentioned above, there is a regulatory issuance threshold which limits the value of assets encumbered for the benefit of covered bond holders to 10% of the total assets of the issuing bank. The RBNZ highlights that this is an initial limit and its appropriateness will be reviewed taking into consideration the development of the covered bond market. The RBNZ stated that the 10% limit is "similar to the limit set in Australia" of 8%. However, the limit is "specified differently" from Australia's. "The New Zealand limit applies at all times, whereas the Australian limit applies only at the time of issuance. In addition, if an Australian bank holds cover pool assets in excess of the limit, it must deduct the value of the excess amount from its capital in calculating its regulatory capital adequacy ratios: if a New Zealand bank breaches its cover pool limit, it is in breach of its conditions of registration."

Currency and interest hedging: The underlying mortgage loans are denominated in NZD. However, covered bonds can be issued in other currency denominations, which introduces currency risk for the issuer. Moreover, the interest payable for the covered bonds will not exactly match the interest received on the mortgage loans in the collateral pool. Under the existing covered bond programmes, the issuers are required to hedge the interest and currency risks.

Soft vs hard bullet structures: The existing issuers (ANZ, ASB, BNZ, Kiwibank and Westpac) can issue hard bullet covered bonds, or covered bonds with extendable maturity of one year ("soft bullet" bonds). Hard bullet covered bonds will be subject to a 12-month pre-maturity test giving the CB guarantor 12 months to raise liquidity by selling assets of the pool.

Over-collateralisation (OC): The issuers have committed to various OC levels under the prospectuses and to the rating agencies. The covered bond law only requires that the value of the cover pool assets is at least equal to the principal amount outstanding on the covered bonds.

VI. COVER POOL MONITOR AND BANKING SUPERVISON

The law stipulates that registered covered bond issuers must appoint an independent asset monitor. The asset monitor must either be a licensed auditor or an auditing firm (or a person/firm that has been approved by the RBNZ). In this context independent means independent of both the issuer and any associated person of the issuer whereby a person's appointment as auditor does not affect his, her, or its independence.

The existing issuers provide investor reports on a monthly or quarterly basis. In addition, monthly or quarterly reports are prepared for the rating agencies. The agencies re-calculate the required asset percentage used in the ACT on a regular basis and prior to each issuance under the respective covered bond programme. On an annual basis the asset monitor checks the arithmetic accuracy of the calculations performed by the calculation manager (usually the issuer), with respect to the asset coverage test or amortisation test (as applicable).

The law introduces the requirement for an asset register to be maintained. The asset monitor also carries out an annual check that the asset register has been updated accurately and in a timely manner.

If the issuer rating of the calculation manager is downgraded below a certain trigger level, the asset monitor will check the arithmetic accuracy of the calculations performed by the calculation manager on a monthly basis. Moreover, (1) if the asset monitor identifies any errors in the calculations performed by the calculation manager which result in a failure in the asset coverage test, or (2) if the adjusted aggregate mortgage loan amount or the amortisation test aggregate mortgage loan amount is misstated by the calculation manager by an amount exceeding 1%, or (3) if the asset register has not been maintained as required, then the asset monitor will be required to carry out the applicable check on a monthly basis until the asset monitor is satisfied that no further inaccuracies exist.

VII. SEGREGATION OF COVER ASSETS AND BANKRUPTCY REMOTENESS OF COVERED BONDS

The covered bonds are direct, unsecured, unsubordinated and unconditional obligations of the relevant issuer. In addition, the CB guarantor guarantees the payments of interest and principal of the covered bonds. The issuer provides a subordinated loan to the CB guarantor which allows the CB guarantor to acquire a mortgage loan portfolio. The portfolio includes mortgage loans and the related security sold by the seller in accordance with the terms of the mortgage sale agreement.

The mandatory registration required by the new covered bond law involves the recognition of a covered bond issued with the effect that the cover assets would be explicitly protected from the insolvency or statutory management of the issuer. The RBNZ must keep a public register of registered covered bond programmes and issuances under each programme. Moreover, the covered bond law requires that the cover pool assets are held by a Special Purpose Vehicle (SPV), which is a separate legal entity from the issuer.

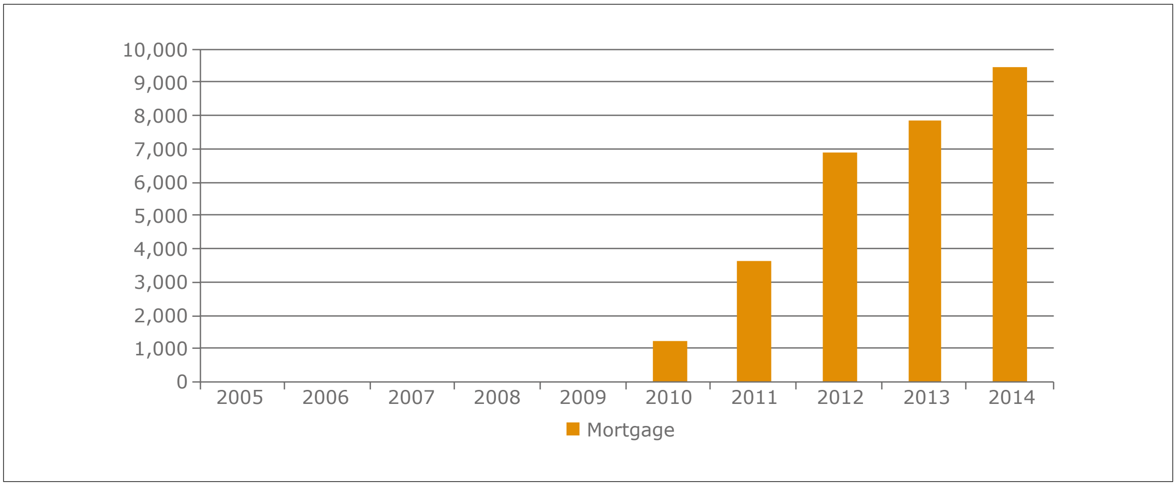
Under the existing covered bond programmes, the sale of the loans and their underlying security by the seller to the CB Guarantor is in the form of equitable assignment of the seller's rights, title, interest and benefit in and to the loans, their related security and the other assets which are being sold. The equitable assignment requires neither a notice to the borrowers nor a registration in the land registry. As a result, the legal title to the mortgage loans remains with the seller until legal assignment is delivered to the CB guarantor and notice of perfection of legal title is given to the borrowers. The perfection of title of the mortgage security to the CB guarantor will be triggered by certain trigger events including the notice to pay on the CB guarantor, downgrade of the issuer to sub-investment grade or insolvency of the issuer. The equitable assignment is a well-known procedure in the UK and is usually used by the covered bond issuers in the UK.

VIII. RISK-WEIGHTING AND COMPLIANCE WITH EUROPEAN LEGISLATION

The RBNZ accepts NZD denominated AAA rated covered bonds for its Domestic Markets Operations. For maturities of less than three years the haircut is 5% while covered bonds with a maturity of three years or longer are subject to a higher haircut of 8%. This includes covered bonds issued by New Zealand banks.

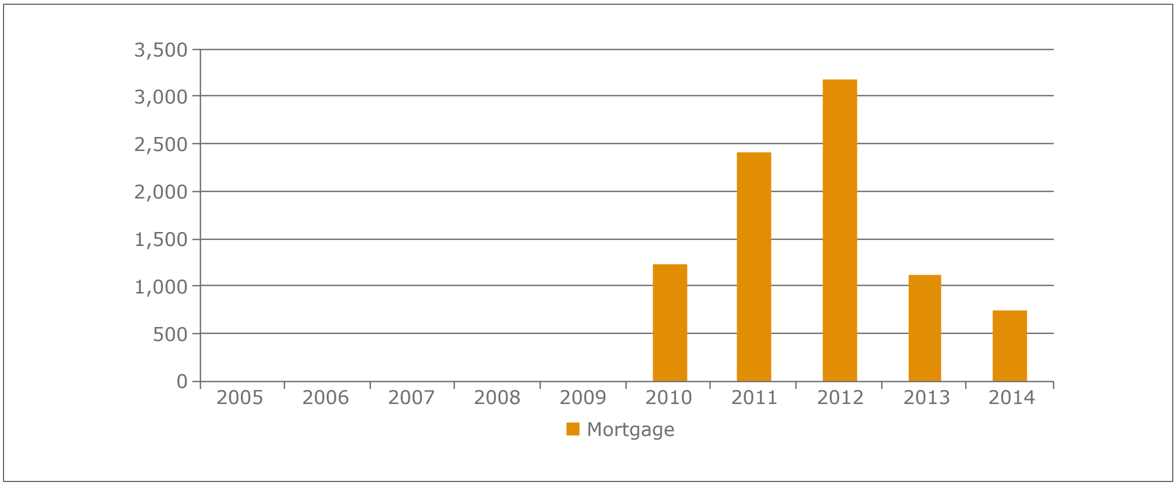
The covered bonds issued directly by financial institutions with registered offices in New Zealand are neither CRR nor UCITS compliant as both frameworks require the issuer to be based in the EU. The New Zealand covered bonds, therefore, do not benefit from the lower risk weighting for bank treasuries in the EU.

> Figure 1: Covered Bonds Outstanding, 2005-2014, EUR m



Source: EMF-ECBC

> Figure 2: Covered Bonds Issuance, 2005-2014, EUR m



Source: EMF-ECBC

Issuers: ANZ Bank New Zealand, ASB Bank, Bank of New Zealand, Kiwibank, Westpac Securities NZ.

3.22 NORWAY

By Torkil Wiberg, Finance Norway

I. FRAMEWORK

In June 2015 the Norwegian covered bond legislation passed its eighth year milestone. The legislation was a result of a lengthy study and is closely matching corresponding EU directives and regulations, in particular the CRD IV/CRR and UCITS Directive. The legislative framework has so far proved to be a solid and sustainable base for the issuers' commercial activity. The law provides investors strong protection from the issuing institution's cover pool, and the Norwegian covered bonds are seen as being among the best in class of European covered bonds. The high quality of Norwegian covered bonds is supported by the Kingdom of Norway's very strong macroeconomic position.

Three specialised institutions were established from the beginning and started issuance of Norwegian covered bonds in international markets during the second half 2007. This activity had thus barely started when the crisis hit the international financial markets the following year. In order to provide liquidity to the Norwegian banking market the authorities opted to swap treasury bills against covered bonds with Norwegian banks and mortgages institutions. This gave an impetus to the fledgling domestic market of covered bonds; a large number of banks established new subsidiaries in order to take advantage of this liquidity window. Today there are 22 Norwegian specialized credit institutions licensed to issue covered bonds. The smallest ones only operate in the domestic market. The largest issuers already have been, and are expected to continue to be, present in the international capital markets on a regular basis.

II. STRUCTURE OF THE ISSUER

The Norwegian Covered Bond legislation entered into force on 1 June 2007. Relevant amendments were made to the Financial Services Act, hereafter "the Act", and, at the same time, the Ministry of Finance adopted a supplementary regulation, hereafter "the Regulation", to the Act. The legislation permits specialized mortgage credit institution to raise loans by issuing covered bonds. These institutions are licensed credit institutions, supervised by the Financial Supervisory Authority of Norway – Finanstilsynet, hereafter the FSA. They are subject to the same type of regulations as other Norwegian financial institutions, for example capital adequacy requirements, general requirements for liquidity management etc.

A commercial bank or a savings bank will not be allowed to issue such bonds in its own name, but may establish a mortgage credit institution as a subsidiary. Alternatively, a mortgage credit institution may be established as an independent institution with several shareholders.

A licensed mortgage credit institution may raise loans by issuing covered bonds where the object of the institution, as laid down in the articles of association, is (1) to grant or acquire specified types of mortgages and public sector loans and (2) to finance its lending business primarily by issuing covered bonds. The articles of association of the institution shall state which types of loans that shall be granted or acquired by the institution. The scope of the business will therefore be restricted and the institution will have a very narrow mandate. Thus, Norwegian issuers of covered bonds are transparent companies.

III. COVER ASSETS

According to the Act the cover pool may consist of the following assets:

> Residential mortgages

> Commercial mortgages

> Loans secured on other registered assets (subject to further regulations)

> Public sector loans

> Assets in form of derivative agreements (in accordance with the Regulation)

> Substitute assets (in accordance with the Regulation)

The mortgage loans have to be collateralized with real estate or other eligible assets within the EEA or OECD, and the public sector loan borrowers have to be located within the EEA or OECD. The Regulation adds rating requirements on the individual public sector borrowers, if located outside the EEA.

The derivate agreements and the substitute assets are, logically, accessory to the loans. The substitute assets may only amount to 20% of the cover pool (30% for a limited period of time with the consent of the FSA). In addition, the substitute assets ought to be secure and liquid. The Regulation adds requirements necessary in order to comply with the description of covered bonds given in the EU Capital Requirements Regulation (CRR). Counterparty and rating regulations in accordance with the directive apply to these two asset classes, as well as to the public sector loans.

IV. VALUATION AND LTV CRITERIA

Loan to value ratios (LTV) and monitoring are fixed by the Regulation, in accordance with the CRR. For residential mortgages the LTV is 75%. For holiday houses and commercial mortgages the LTV-limit is 60%. The mortgage credit institution shall monitor the development of the LTV of the individual asset as well as the market of the underlying assets, according to the Act, and in accordance with the said directive.

Upon inclusion of loans in the cover pool, a prudent market value shall be set. The market value for a property shall be set individually by an independent and competent person. The valuation shall be documented. However, valuation of residential properties may be based on general price levels.

Predominantly, residential properties in Norway are sold in open auctions in the market. Hence the actual selling price in principle reflects the market value and a recent sales contract may serve as documentation of the market value of a property.

The mortgage institution shall establish systems for monitoring subsequent price developments. Should property prices later fall, that part of a mortgage that exceeds the relevant LTV limit is still part of the cover pool and protects the holders of preferential claims. However, that part of a loan that exceeds the LTV limit is not taken into account when calculating the value of the cover pool to compare it with outstanding covered bonds, please refer to the matching regulations as described below. The same principle applies to loans that are in default, i.e. more than 90 days in arrears.

V. ASSET – LIABILITY MANAGEMENT

TAt inception the Act established a strict balance principle, i.e. the value of the cover pool shall at all times exceed the value of the covered bonds with a preferential claim over the pool, and there was no requirement for a certain percentage of overcollateralization (OC). However, a new act on financial institutions passed in April 2015 and enters into force in January 2016, authorises the Ministry of Finance to set a minimum overcollateralisation requirement. The regulation establishes a strict mark to market principle of both assets and liabilities. Only the value of mortgages within the LTV limits is taken into account in this context. Also, the act caps the maximum exposure to one single borrower at 5% of the cover pool when compliance with the matching requirement is assessed.

All voluntary OC, is part of the cover pool, and bankruptcy remote in case of the issuer going into bankruptcy proceedings. The issuing institutions typically declare a certain level of OC, e.g. 5%, to which they are bound. Equally, the mortgage credit institution shall ensure that the payment flows from the cover pool enable the institution to honour its payment obligations.

The mortgage institution may enter into derivative agreements in order to secure the balance principle and payment obligations. If it has a positive market value, a derivative agreement will be part of the cover pool; if negative, the counterparties to derivative agreements will have a preferential claim over the pool, pari passu with the holders of covered bonds. As a corollary to this, the counterparties in the derivative agreements will be subject to same restrictions with respect to declaration of default as the bondholders. In addition to this, the mortgage institution will have to adopt strict internal regulations with respect to liquidity risk, interest rate risk and currency risk.

VI. TRANSPARENCY

Growing investor activism has initiated a work aimed at increasing transparency in the issuing institutions and in particular in the cover pool. At the initiative of an international investor organization, the Covered Bond Investor Council, The Norwegian Covered Bond Council undertook the task to establish a Norwegian template, in accordance with the one from CBIC. The Norwegian template was published on The Norwegian Covered Bond Council's web page early 2012, see Finance Norway's website: https://www.fno.no/en/covered-bonds/cbic-european-transparency-standards/, or the Covered Bond Label website: https://www.coveredbondlabel.com/issuers/national-information-detail/17/. As of May 2015 there are four Norwegian issuers labelled (DNB Boligkreditt, Eika Boligkreditt, Nordea Eiendomskreditt and SpareBank 1 Boligkreditt).

The template sets transparency standards for the cover pool data that individual issuers want to publish. Links to the different issuers' individual websites, containing the cover pool information, are available on The Norwegian Covered Bond Council's web page: https://www.fno.no/en/covered-bonds/. The Norwegian Covered Bond Council updated the template in 2014 to provide harmonised reporting in relation to Article 129 (7) CRR.

VII. COVER POOL MONITOR AND BANKING SUPERVISION

Mortgage and other credit institutions are regulated under Chapter 3 of the Act. This chapter sets out the general provisions for a credit institution, i.e. the obligation to obtain a license and to fulfill capital requirements and undertake organizational measures etc.

The issuing of covered bonds is regulated by Chapter 2, Subchapter IV of the Act. The issuance of such bonds is not subject to any further governmental approvals. However the articles of association shall be approved by the FSA. Furthermore, the institution shall notify the FSA no later than 30 days prior to the initial issuance of covered bonds. The FSA has the power to instruct licensed mortgage institutions not to issue covered bonds whenever the financial strength of the institution gives rise to concern.

The mortgage institution shall maintain a register of issued covered bonds and of the cover assets assigned thereto, including derivative agreements. To oversee that the register is correctly maintained an independent inspector shall be appointed by the FSA. The inspector shall also regularly review compliance with the requirements concerning the balance principle, and report to the FSA, yearly or whenever the institution does not comply.

VIII. SEGREGATION OF COVER ASSETS AND BANKRUPTCY REMOTENESS OF COVERED BONDS

The Act gives the bondholders a preferential claim over the cover pool in case of bankruptcy. The term "covered bonds", or literally "bonds with preferential claim" (in Norwegian "obligasjoner med fortrinnsrett") is protected by law. In case of bankruptcy of the mortgage credit institution an administrator shall be appointed by the court. The assets in the pool remain with the estate in case of bankruptcy, but the bondholders have exclusive, equal and proportionate preferential claim over the cover pool, and the administrator is bound to assure timely payment, provided the pool gives full cover to the said claims.

The preferential claim also applies to payments that accrue to the institution from the cover pool. And, as long as they receive timely payments, the creditors have no right to declare default. Details about this may be reflected in the individual agreements between the issuer and (the trustee of) the bondholders. These provisions will also apply to any netting agreements between the institution and its counterparties in derivative transactions.

Bankruptcy or insolvency does not in itself give holders of covered bonds and derivative counterparties right to accelerate their claims. However, should it not be possible to make contractual payments when claims fall due, and an imminent change that will ensure such contractual payments is unlikely, the bankruptcy manager shall introduce a halt to payments. Thereafter further administration of the cover pool shall proceed under the general bankruptcy legislation.

IX. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

The legislation fulfils and is in compliance with the relevant EU legislation, i.e. the Capital Requirements Regulation (CRR) and in particular Article 52 (4) UCITS.[1] Hence, the Norwegian Covered Bonds being in compliance with the CRR and the UCITS are eligible for reduced (10%) risk-weighting under the standard method for capital adequacy requirement. The Norwegian Covered Bonds are also eligible as collateral in ECB and qualify as liquid assets under the Liquidity Coverage Ratio (LCR) given fulfillment of the specific criteria defined in the Delegated Act.

The issuers are licensed credit institutions under supervision of the Norwegian FSA, and as such bound to comply with all relevant single market directives and regulations applicable to European credit institutions.

X. ADDITIONAL INFORMATION

Legislation supplementing the covered bond legislation

The legal framework regulating the housing market is well developed. This framework provides legal certainty and foreseeability for both consumers as borrowers and owners of housing, and for credit institutions as lenders and creditors. This includes specific consumer protection legislation, a centralized electronic registry system for the ownership of and rights (mortgage, etc.) in real estate, and an effectively and expedient forced sale procedure.

The Financial Contracts Act (Act 1999-06-25 no. 46) regulates the contractual conditions in respect of a loan agreement between financial institutions and their customers, both consumers and corporate clients. The Act applies in principle to all types of loans, whether they are secured or not. This also includes mortgage backed loans included in a cover pool. The act is invariable in respect of consumer contracts, i.e. it cannot be dispensed with by agreement that is detrimental to the customer.

The Mortgage Act (Act of 8 February 1980 no. 2) regulates i.a. mortgages on real estate. Mortgage rights acquire legal protection by registration in the Land Registry/Register of Deeds.

The Forced Sales Act (Act of 26 June 1992 no.86) provides for an effectively and expedient forced sale procedure. A lender may, if a loan is accelerated and the borrower fails to pay any due amount, file an application before the county court for a forced sale of the property that backs the mortgage loan. The registered mortgage contract will itself constitute basis for such application. The court will normally appoint a real estate broker to administer the sale in order to obtain a reasonable price. Normally, nine to twelve months are required to repossess the property and satisfy the holder of a mortgage.

Market overview

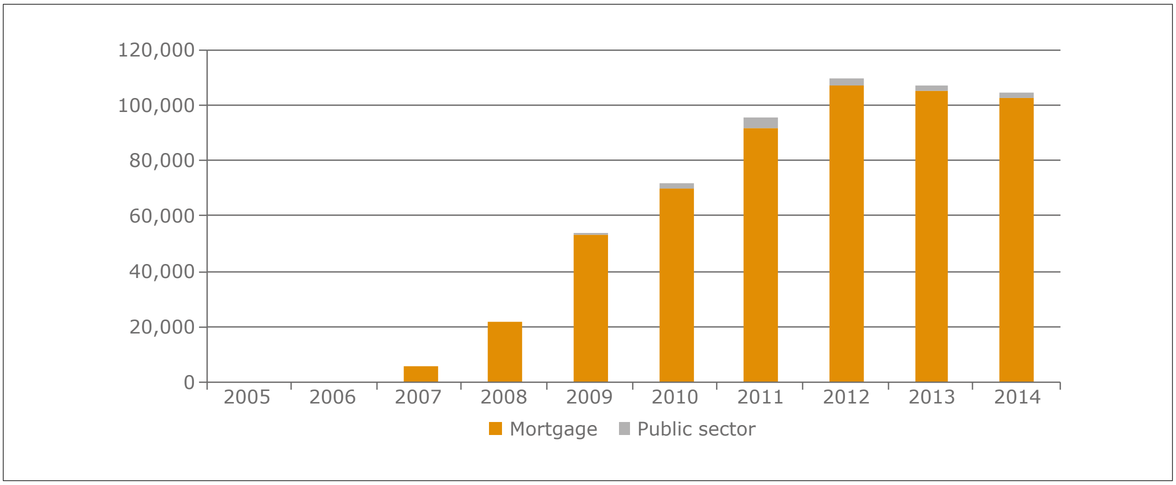
The covered bonds are listed. Virtually all active issuers have issues listed on the Norwegian market places offered by Oslo Børs, either on the regulated market or on Oslo ABM, the non-regulated market place run by Oslo Børs. International issues may be listed in a financial centre abroad.

[1] Please click on the following link for further information on the UCITS Directive and the Capital Requirements Regulation (CRR): http://ecbc.hypo.org/Content/default.asp?PageID=504#position.

The Norwegian Government's swap program that was introduced to provide extra liquidity to the market at the outbreak of the financial crisis was discontinued by end 2009. Since then, there has been no government sponsored program stimulating the market for covered bonds. The last covered bonds that remained in the swap agreement, which in total amounted to NOK 230 bn. (ca. EUR 30 bn.), came to maturity in June 2014. The transaction activity and the liquidity in the Norwegian market have showed an increasing trend since the improvement of the capital markets after the financial crisis and is by market participants considered to be very liquid. As a measure for further improving secondary market liquidity and transparency, the Oslo Stock Exchange launched the *Norwegian Covered Bond Benchmark List* in June 2014. Bonds listed on the Benchmark list will be subject to continouos indicative quotation, which will contribute to enhanced transparency in the Norwegian covered bond market.

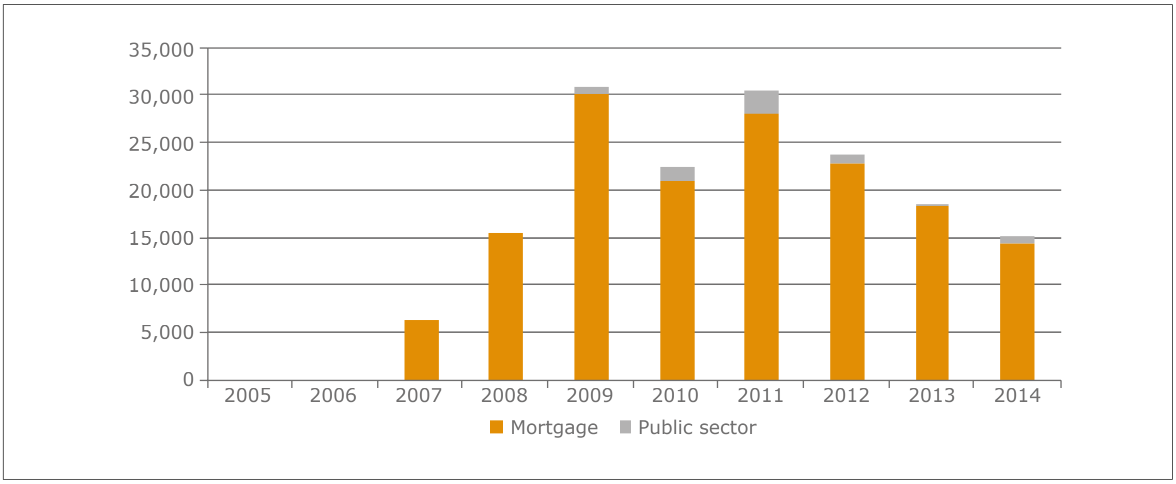
Norwegian covered bond issuers issued a total of EUR 15,138 bn. during 2014. Of this amount approximately 65 % was issued in domestic currency (NOK). 4,6bn. was placed in euros, while other currency issuance accounted for around EUR 694 million. Although the primary market activity fell slightly in 2014 relative to 2013, the total outstanding volume remained above the EUR 100 bn. mark at the end of the year and exceeds the Norwegian government bond market in size.

> Figure 1: Covered Bonds Outstanding, 2005-2014, EUR m



Source: EMF-ECBC

> Figure 2: Covered Bonds Issuance, 2005-2014, EUR m



Source: EMF-ECBC

Issuers: Bustadkreditt Sogn og Fjordane AS, Landkreditt Boligkreditt AS, Møre Boligkreditt AS, Nordea Eiendomskreditt AS, Sparebanken Sør Boligkreditt AS, Gjensidige Bank boligkreditt AS, Fana Sparebank Boligkreditt AS, DNB Boligkreditt AS, DNB Næringskreditt AS, Storebrand Boligkreditt AS, Helgeland Boligkreditt AS, Verd Boligkreditt AS, Sparebanken Vest Boligkreditt AS, Totens Sparebank AS, Sparebanken Øst Boligkreditt AS, Eiendomskreditt AS, Eika Boligkreditt AS, Sparebank 1 Boligkreditt AS, Sparebank 1 Næringskreditt AS, Sandnes Sparebank Boligkreditt AS, KLP Kommunekreditt AS, KLP Boligkreditt AS.

ECBC Covered Bond Comparative Database: http://ecbc.eu/framework/75/Norway.

Covered Bond · L A B E L · **:** DNB Boligkreditt mortgage cover pool; Eika Boligkreditt AS cover pool; Nordea Eiendomskreditt cover pool; Sparebank 1 Boligkreditt (Spabol).

3.23 PANAMA

By Frank Will, HSBC & Chairman of the ECBC EU Legislation Working Group

I. FRAMEWORK

In September 2012, Global Bank became the first issuer of covered bonds out of Panama. It was also Latin America's inaugural covered bond. The USD 200 m deal was issued under Global Bank's USD 500 m Residential Mortgage Loans Covered Bond Programme. In October 2013, the bond was increased by USD 100 m. As of June 2015, we have not seen any new issuance or new covered bond issuers out of Panama.

Panama currently does not have a specific legal framework for covered bonds. Thus, Panamanian covered bonds are based on contractual agreements and the programme characteristics are self-imposed. Similar to the structures used in other markets without a specific covered bond law, many programme features are derived from securitisation techniques. Please note that our country analysis is based on the only available covered bond programme in Panama to date, i.e. the one from Global Bank.

II. STRUCTURE OF THE ISSUER

In the absence of a specific covered bond law in Panama, Global Bank Corp. y Subsidiarias used certain securitisation techniques and contractual law to replicate the key features of specific law based covered bonds and to ensure that the cover pool is isolated in the event of issuer insolvency. The covered bonds represent direct unconditional and unsubordinated obligations of the issuer and rank pari passu among themselves. The covered bond programme has a separate cover pool of Panamanian residential mortgage assets that is transferred to a guaranty trust. The covered bond holders have a priority claim on these assets.

III. COVER ASSETS

Given the lack of other Panamanian covered bond issuers, we focus below on the asset requirements of Global Bank's covered bond programme. Under the programme, the covered bonds are backed by a dynamic pool of first-ranking residential mortgage loans originated in Panama.

The residential mortgage loans are subject to various eligibility criteria:

- The loans must be denominated in USD;
- The mortgage borrowers must be individuals resident in Panama;
- Each loan is secured by a valid and enforceable mortgage or by a guaranty trust, in accordance with Panamanian Law over a fully completed residential property located in Panama;
- With respect to any loan, there are no other loans secured by mortgages or by a guaranty trust ranking pari passu or senior with the mortgage or guaranty trust securing such loan (if there are other loans secured by mortgages or by a guaranty trust and ranking pari passu or senior with the mortgage or guaranty trust securing such loan, such loans have also been originated by the issuer and are included in the portfolio);
- No loan has a current principal balance of more than USD 500,000;
- Each loan has a remaining term of no longer than 30 years; and,
- No loan that has been transferred to the guarantee trust has been more than 90 days in arrears during the calendar year preceding the transfer date.

The aggregate principal amount of substitution assets (and/or authorised investments) may not at any time exceed 20% of the aggregate principal balance of the Guaranty Trust Assets.

IV. VALUATION AND LTV CRITERIA

The maximum permitted LTV is 100% in Global Bank's covered bond programme. For non-preferential first lien mortgages the LTV caps are lower (95% for employed borrowers, 85% for self-employed and 70% for foreign borrowers). The Asset Coverage Test does not give any credit to mortgage loans more than 90 days past due. The maximum asset percentage is set at 84.4%.

V. ASSET – LIABILITY MANAGEMENT

Global Bank's covered bond programme features several tests including an Asset Coverage Test, an Interest Shortfall Test, a Yield Shortfall Test and an Amortisation Test.

> **Asset Coverage Test:** The Asset Coverage Test is breached if, on any calculation date prior to the occurrence of an issuer event of default and the service of a notice to pay on the guaranty trustee, the adjusted aggregate loan amount is less than the aggregate principal amount outstanding of the covered bonds.

> **Interest Shortfall Test:** The Interest Shortfall Test is breached when, on any calculation date prior to the occurrence of an issuer event of default and service of a notice to pay on the guaranty trustee, the income received with respect to the guaranty trust assets (including interest received or amounts received on hedging instruments) during the calculation period plus other available amounts (representing interest) is less than the interest amounts expected to accrue under the covered bonds during the next succeeding guaranty trust payment period.

> **Yield Shortfall Test:** The Yield Shortfall Test is breached when, on any calculation date following an issuer event of default and service of a notice to pay on the guaranty trustee, interest amounts under the loans and other amounts (representing interest) received by the guaranty trustee in respect of the guaranty trust assets during the calculation period cease to give a yield on the loans at least equal to the weighted average interest rate on the outstanding series of covered bonds.

> **Amortisation Test:** The Amortisation Test is breached if, for so long as any covered bonds remain outstanding upon the occurrence of an issuer event of default and on any calculation date following the occurrence of an issuer event of default and the service of a notice to pay on the guaranty trustee (but prior to the service of a guaranty trust acceleration notice), the amortisation test aggregate loan amount is less than the aggregate principal amount outstanding of the covered bonds as at the determination date.

The issuer can issue covered bonds in hard-bullet or soft-bullet format. In case of soft-bullet bonds, the outstanding covered bonds' maturity will automatically be extended by up to 12 months if the issuer fails to fully redeem a series.

VI. TRANSPARENCY

Global Bank's prospectus requires the bank to prepare a monthly investor report listing selected statistical information in relation to the underlying portfolio and the characteristics of the portfolio as well as confirming compliance with the Asset Coverage Test. The issuer provides comprehensive information on the borrowers (income brackets, employment type, life insurance), delinquency rates, fire & earthquake insurance of the properties, loan-to-value ratios by brackets and charged interest rates.

VII. COVER POOL MONITOR AND BANKING SUPERVISION

The asset monitor reports on the arithmetic accuracy of the calculations performed by the cash manager on the calculation date immediately prior to the guaranty trust payment date at the end of each fiscal quarter with a view to confirmation of compliance with the Asset Coverage Test or the Amortisation Test on that calculation date. Following the occurrence of a servicer termination event, the asset monitor will, subject to receipt of the relevant information from the cash manager, be required to report on such arithmetic accuracy following each calculation date and, following a determination by the asset monitor of any errors in the calculations performed by the cash manager such that the Asset Coverage Test has been failed on the applicable calculation date or the adjusted aggregate loan amount or the amortisation test aggregate loan amount is misstated by an amount exceeding one per cent of the adjusted aggregate loan amount or the amortisation test aggregate loan amount, the asset monitor will be required to verify the procedures and calculations made by the cash manager on each calculation date for a period of six months thereafter.

The cash manager will check compliance with the tests on each calculation date. The asset monitor will periodically check compliance. If any of the tests noted above are not satisfied and the breach is continuing, the issuer must take prompt remedial action. The issuer will immediately notify the trustee of the breach of any of the tests. In the event of a breach of either the Asset Coverage Test or the Interest Shortfall Test which is continuing, the issuer will not be permitted to issue.

VIII. SEGREGATION OF COVER ASSETS AND BANKRUPTCY REMOTENESS OF COVERED BONDS

As mentioned above, the covered bonds are direct and unconditional obligations of the issuer but are secured by the guaranty trust assets. The guaranty trustee has no obligation to pay the amounts set out in the guaranty trust priority of payments until the occurrence of an issuer event of default, service by the trustee on the issuer of an issuer acceleration notice and on the guaranty trustee of a notice to pay. There are a number of features of the programme which are intended to enhance the likelihood of timely payments to covered bond holders: (1) the guaranty trust assets secure the obligations of the issuer in respect of the covered bonds; (2) the Asset Coverage Test is intended to test the asset coverage of the guaranty trust assets in relation to the covered bonds prior to the occurrence of an issuer event of default, service of an issuer acceleration notice on the issuer and service of a notice to pay on the guaranty trustee; and last but not least (3) the Amortisation Test is intended to test the asset coverage of the guaranty trust assets in relation to the covered bonds following the occurrence of an issuer event of default, service of an issuer acceleration notice on the issuer and service of a notice to pay on the guaranty trustee.

If an issuer event of default occurs then, for so long as such issuer event of default is continuing, (i) no further covered bonds may be issued and (ii) following service of a notice to pay on the guaranty trustee, the guaranty trust available funds will be dedicated exclusively to the payment of interest and repayment of principal on the covered bonds and to the fulfilment of the obligations of the issuer to the other creditors in accordance with the guaranty trust priority of payments.

All covered bonds issued from time to time will rank pari passu with each other in all respects. If an issuer event of default occurs in respect of a particular series of covered bonds, then, following the service of an issuer acceleration notice, the covered bonds of all series outstanding will accelerate at the same time against the issuer but will be subject to, and have the benefit of, payments made by the guaranty trustee under the Guaranty Trust Agreement (following service of a notice to pay on the guaranty trustee). Payments by the cash manager on behalf of guaranty trustee under the Guaranty Trust Agreement in relation to such covered bonds will continue to be required to be made on their original due for payment date. If a guaranty trust event of default occurs, following service of a Guaranty Trust Acceleration Notice, the covered bonds of all series outstanding will accelerate against the issuer (if not already accelerated following an issuer event of default) and the obligations of the guaranty trustee under the Guaranty Trust Agreement will also accelerate against the guaranty trustee.

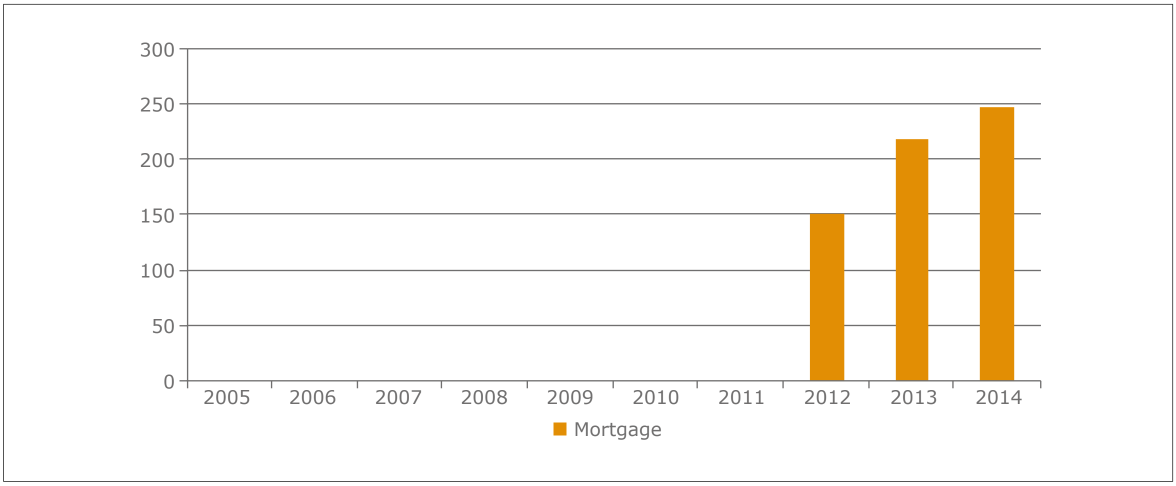
In order to ensure that any further issue of covered bonds under the programme does not adversely affect existing holders of the covered bonds, the Asset Coverage Test will be required to be met both before and after any further issue of covered bonds and, on or prior to the date of issue of any further covered bonds, the issuer will be obliged to obtain written confirmation from the rating agencies that such further issue would not adversely affect the ratings of the existing covered bonds. Nevertheless, there can be no assurance that any further issuances will not adversely affect existing holders of the covered bonds.

IX. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

Global Bank's covered bonds are neither Article 52(4) UCITS-compliant nor Article 129 CRR-compliant as Panama is not a Member State of the European Union (EU). In addition, Panama does not have national covered bond legislation. Therefore, the covered bonds do not benefit from a preferred risk-weighting for regulatory capital purposes under EU rules. Under the Standardised Approach, they are treated similarly to senior unsecured bank debt.

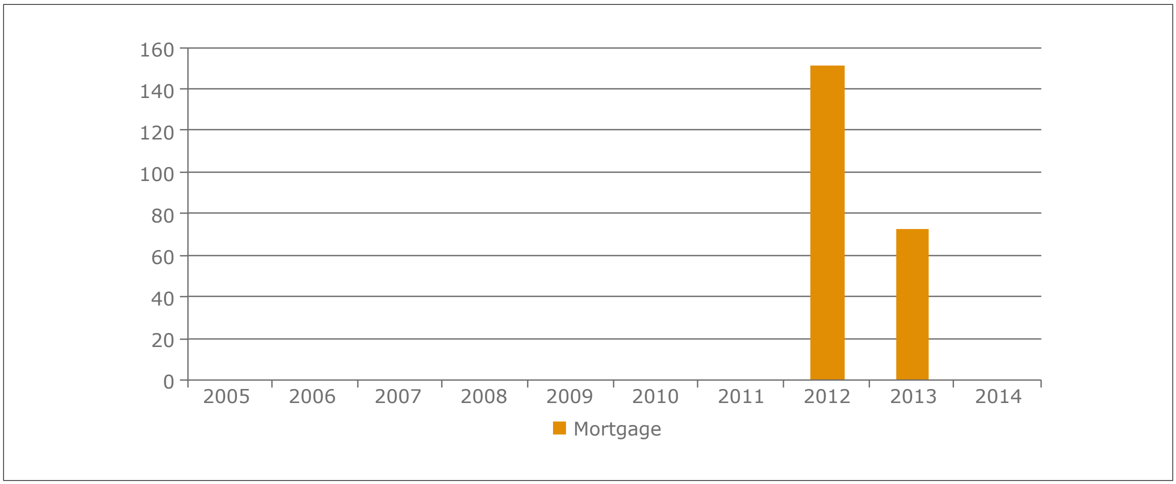
As Panama is neither an European Economic Area (EEA) country nor a G10 country, Panamanian covered bonds are not eligible for the European Central Bank repo operations regardless of their currency and their rating.

> Figure 1: Covered Bonds Outstanding, 2005-2014, EUR m



Source: EMF-ECBC

> Figure 2: Covered Bonds Issuance, 2005-2014, EUR m



Source: EMF-ECBC

Issuers: Global Bank Corp (Panama)

3.24 POLAND

By Agnieszka Tułodziecka, Polish Mortgage Credit Foundation, and Piotr Cyburt, mBank Hipoteczny

I. FRAMEWORK[1]

The legal framework for Polish covered bonds (Listy Zastawne, also LZ) is determined by:

> The Act on Covered Bonds and Mortgage Banks (*Ustawa o listach zastawnych i bankach hipotecznych*) of August 29, 1997; (The List Zastawny Act – hereafter: The LZ Act).

> The Bankruptcy and Reorganization Law (*Prawo upadłościowe i naprawcze*) of February 28, 2003, Chapter II – Bankruptcy proceedings for mortgage banks, Article 442–450.

In 2014, key under-law regulations for mortgage banks were amended by Polish Financial Supervision Authority:

> Recommendation F – the standards for determining mortgage-lending value were ease.

> Recommendation K – the rules on keeping and managing cover registers were actualised.

Both recommendations were to be implemented by January 1, 2015.

II. STRUCTURE OF THE ISSUER

The issuer is a specialised credit institution (mortgage bank) with the supervision of Polish Financial Supervision Authority (*Komisja Nadzoru Finansowego*, KNF). It is required by law that the mortgage bank is a joint stock company with a legal personality (not a branch) with two licences: a banking licence and consent to start operating activity, both granted by the KNF.

Since 23 February 2011 there is one more entity authorised to issue covered bonds. The additional covered bond issuer is Poland's only state-owned bank, Bank Gospodarstwa Krajowego (BGK), which may issue covered bonds to finance government programmes in particular. However, there have been no issues of BGK so far.

According to the LZ Act, a mortgage bank is limited in its range of business activities, i.e. it may only engage in activities specified in a closed catalogue. The operations of a mortgage bank can be divided into two groups: core and non-core and may be also executed in foreign currencies upon obtaining relevant authorisations.

The core operations which may be performed by mortgage banks include:

> granting loans secured with mortgages,

> granting loans where the borrower, guarantor or underwriter of a loan repayment is the National Bank of Poland, European Central Bank (ECB), governments or central banks of the European Union (EU) member states, Organisation for Economic Cooperation and Development (OECD), or where a guarantee or security is granted by the State Treasury,

> acquisition of other banks' receivables on account of loans granted by them,

> issuing mortgage covered bonds,

> issuing public sector covered bonds.

Apart from core operations, mortgage banks may engage in accepting term deposits, taking credits and loans, issuing bonds, safekeeping securities, keeping bank accounts for servicing investment projects funded by a mortgage bank, providing consulting and advice with respect to the property market, managing receivables of a mortgage bank and other banks arising from mortgage-backed loans, as well as granting such loans on behalf of other banks on the basis of relevant cooperation agreements.

[1] Please note that the Polish parliament approved amendments to the national law on covered bonds and mortgage banks in June 2015, which are not tackled in this article.

A mortgage bank is not authorised to perform any other activities apart from the operations listed above. Particularly, it cannot service savings accounts. Such limitations facilitate maintaining a more simplified and clear activity structure and the specialisation of the loan division as well as the improvement of credit risk assessment methods in the field of real estate financing. Furthermore, funds obtained from covered bond issues shall be used mainly for funding the lending activity of a mortgage bank.

III. COVER ASSETS

All covered bonds must be fully secured by cover assets. There are two specific classes of the covered bonds: *hipoteczne listy zastawne* (mortgage covered bonds) and *publiczne listy zastawne* (public covered bonds); registered in two separate cover registers.

The cover register for mortgage bonds

Mortgage banks in Poland focus on mortgage or public sector lending. They are held on the balance sheet of the issuer and registered in two separate cover registers, which form two separate cover pools.

There are two specific classes of covered bonds which correspond to each of the cover assets:

- hipoteczne listy zastawne (mortgage covered bonds) and
- publiczne listy zastawne (public sector covered bonds).

Both mortgage and public sector covered bonds are direct and unconditional obligations of the issuer and must be fully secured by cover assets of the respective class. Upon the issuer's default covered bondholders have a dual-recourse to a segregated cover pool of assets and, if the cover pool proves to be not sufficient, an unsecured claim against the issuer. Furthermore, the covered bondholders benefit from a statutory priority claim over all the assets in the cover pool (ranking *pari passu*).

Pursuant to the LZ Act, the substitution assets can be included in the cover pool i.e. up to 10% of the mortgage cover pool may consist of the bank's funds invested in the securities issued or guaranteed by the National Bank of Poland, ECB, governments or central banks of the EU member states, OECD (with the exclusion of states which are, or were, restructuring their foreign debt in the last 5 years), and the State Treasury, deposited at the National Bank of Poland or kept in cash. Derivatives are eligible for the cover pool.

In addition, receivables secured by mortgages established on buildings which are in the construction process may not in total exceed 10% of the overall value of mortgage-secured receivables in the cover pool. Within this limit, the receivables secured by mortgages on construction lots in compliance with the land use plan may not exceed 10%.

IV. VALUATION AND LTV CRITERIA

The property valuation in a mortgage bank is conducted under the rules stipulated in the LZ Act. According to the Polish covered bond legislation, establishing the mortgage lending value of the property shall be performed with due care and diligence on the basis of an expert's opinion. It shall be prepared by the mortgage bank or other entities with appropriate real estate appraisal qualifications commissioned by the mortgage bank. The mortgage lending value cannot be higher than the market value of the property.

Apart from the assumptions laid down in the LZ Act concerning property valuation in a mortgage bank there are special banking supervisory regulations, which stipulate in details the establishment of the mortgage lending value and impose a duty on a bank to have a database for real estate prices.

For both commercial and residential properties, the funding limit – related to a single loan – is established at the level of 60% of the mortgage lending value of the property (Article 14 LZ Act). In the part above 60% of the mortgage lending value of the property, the total amount of receivables from granting credits secured with mortgages or receivables purchased from other banks arising from their mortgage-secured credits, may not exceed 30% of the total amount of the mortgage bank's receivables secured with mortgages (absolute portfolio limit, Article 13.1 LZ Act).

Apart from funding limit, there is also lending limit, according to Article 13.2 LZ Act, stipulating that single loan granted by a mortgage bank cannot exceed the mortgage lending value of the property.

V. ASSET-LIABILITY MANAGEMENT

According the LZ Act (Article 18), the total nominal value of all outstanding covered bonds (which should be calculated separately for each class) shall not exceed the sum of nominal amounts of (either mortgage or public sector) covered assets, which form the basis for the covered bond issue. Thus, the nominal value of respective covered assets shall permanently be higher than the total nominal value of the respective covered bonds. In addition, the mortgage bank's income from interest on its respective cover assets may not be lower than the amount of bank's payable interest on its respective outstanding covered bonds.

VI. TRANSPARENCY

The information on the activity of Polish mortgage banks can be found on the Polish Mortgage Credit Foundation's website: www.ehipoteka.pl.

The range of data published on a yearly basis comprises:

> new issues of covered bonds,

> outstanding covered bonds (both mortgage and public sector),

> total assets of mortgage banks,

> sales results of residential and commercial credits by mortgage banks.

All Polish covered bonds (public sector and mortgage covered bonds, the latter denominated in PLN as well as in EUR) are listed on the Catalyst, a local bond market operated by WSE and BondSpot. Issuers whose securities are listed on the regulated market are legally bound to provide actual and potential investors with all and any information about their company's economic situation and events which may have an effect on investment risk. Consequently, mortgage banks are obliged to submit disclosures in the form of current and periodic reports, including information on subscription, assigned rating or interest payment dates of covered bonds.

Issuance documents such as Base Prospectus and Supplements for individual series comprising detailed information on the covered bonds as well as the issuer can be found on the issuers' websites:
mBank Hipoteczny: www.mhipoteczny.pl/oferta/listy-zastawne/;
Pekao Bank Hipoteczny: www.pekaobh.pl/u235/navi/31467;
PKO BP Bank Hipoteczny: http://www.pkobh.pl/.

VII. COVER POOL MONITOR AND BANKING SUPERVISION

One of the key features of Polish covered bond legislation (Article 31 LZ Act) is the monitoring role undertaken by the covered pool monitor (*powiernik*) who is appointed by KNF at the request of the mortgage bank's supervisory board. The cover pool monitor is independent and shall not be bound by instructions of the appointing body.

The cover pool monitor is responsible for an ongoing control of the appropriateness of the cover pool management. Its main tasks comprises monitoring of the cover pool (i.e. confirming the accuracy of the inclusion in or removal from the cover register of the cover assets, ensuring that the asset eligibility requirements are met, verifying the correctness of the value registered in the cover pool, etc.) as well as the issuer's compliance with specific provisions of the LZ Act and reporting any breaches of same to the KNF.

The cover pool monitor is required to perform above mentioned tasks not only on an ongoing basis, but also prior to the every issuance of a mortgage bank in order to ensure that a mortgage bank provides an appropriate cover for the planned issue. The issuer is obliged to provide full cooperation to the cover pool monitor and shall give the cover pool monitor the right to review the register, loan documents, accounting books or other bank's documents at its request.

Apart from cover pool's management monitoring performed by the cover pool monitor, mortgage banks fall under the oversight of the KNF which carries out general assessment of Polish banks, including mortgage banks as a part of general banking supervision.

The KNF may commission an independent expert at the expense of the inspected mortgage bank to inspection of the appropriateness of the mortgage bank's entries to the mortgage cover register. This would also including establishing the mortgage lending value of the property was in compliance with the rules referred to in Article 22, paragraph 5 LZ Act.

VIII. SEGREGATION OF COVER ASSETS AND BANKRUPTCY REMOTENESS OF COVERED BONDS

Pursuant to the LZ Act and the Bankruptcy and Reorganization Law (which is complementary to the former in terms of the insolvency issues, containing a separate chapter: Chapter II – Bankruptcy proceedings for mortgage banks – Articles 442-450), in case of bankruptcy of a mortgage bank the receivables, claims and means entered in the cover register shall constitute a separate bankruptcy estate which may be used exclusively to satisfy claims of covered bondholders. Moreover, lunching of the insolvency proceedings does not affect *listy zastawne*, i.e. they do not automatically accelerate when the issuer becomes insolvent and shall be repaid at the time of their contractual maturity.

After declaring a bankruptcy of the mortgage bank, the court appoints the curator (*kurator*) who represents the rights of covered bondholders in the bankruptcy proceedings and notifies the total nominal value of outstanding covered bonds together with accrued interest to the bankruptcy estate. In order to perform these duties the curator has the right to review the accounting books and other documents of the mortgage bank as well as to obtain all the necessary information from the receiver (*syndyk*), court supervisor (*nadzorca sądowy*) and administrator (*zarządca*).

The curator participates in the liquidation of a separate bankruptcy estate performed by the receiver. If possible, the items of such estate may be sold to another mortgage bank.

With a separate bankruptcy estate the following categories should be satisfied successively:

> the costs of liquidation of the estate, including the remuneration of the curator,

> the amounts due to the cover bondholders according to their nominal value,

> interest (coupons).

After satisfying the covered bondholders the surplus of the cover assets deriving from the separate estate shall be allocated to the general bankruptcy estate. In case that the separate bankruptcy estate does not fully satisfy the cover bondholders, the remaining amount shall be satisfied from the whole bankruptcy estate funds. In that case, the remaining amount shall be transferred from the bankruptcy estate funds to the separate bankruptcy estate funds. It indicates that the covered bondholders are given preference over other creditors.

IX. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

In order to apply a preferential risk-weighting for covered bonds, the instrument needs to meet the criteria laid down in the UCITS Directive and the CRR.

Polish covered bonds (*list zastawny*) already meet the criteria of Article 52(4) UCITS: in December 2008 *list zastawny* was notified by the European Commission (EC) as an European "eligible bond" (covered bond), i.e. the instrument with a qualified collateral and can be found on the EC's website at present.

Listy zastawne fall also under the criteria of Article 129(1) of the CRR[2]. The LTV limitation imposed by the LZ Act at the level of 60% corresponds to (or is even more stringent than) the LTV limit stipulated in Article 129 (1)(e) of the CRR which is set forth at the level of 80%. Furthermore, as the previously binding CRD requirements were word–for–word implemented by KNF (see Resolution no. 307/2012), it is to assume that the Polish covered bonds apply for the preferential treatment.

Moreover, *listy zastawne* are listed by the National Central Bank of Poland as the instruments eligible for pawn credit / repo transactions. As of March 2015, the haircut level for repo amounts to 15,0 (3M repo); 20,0 (6 M repo); 25,0 (pawn credit).

Polish investment regulations pertaining to the limits for covered bonds are as follows:

> Banks – no statutory limits, internal concentration limits;

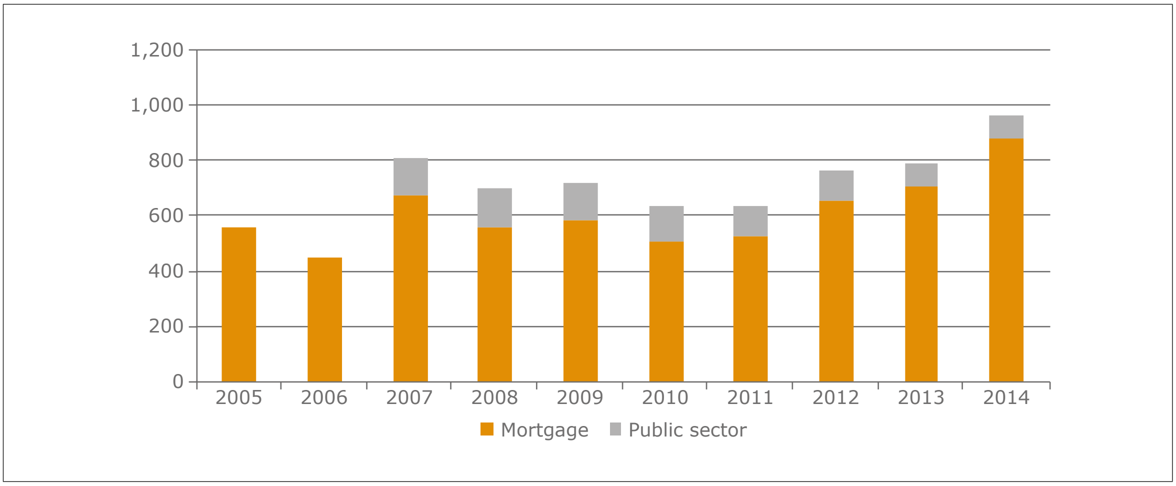
> Insurance companies – up to 40% of technical-insurance reserves – insurance companies (10% in covered bonds which were not allowed to public trading);

> Investment funds – open: 25% of the assets may be invested in covered bonds issued by one mortgage bank; but: total investments in covered bonds may not exceed 80% of the fund’s assets and total value of investments in securities or in monetary market instruments, issued by the same mortgage bank, deposits in that entity, as well as the total value of risk connected with the transactions on non-standardised derivatives, which were dealt with that bank, can’t exceed 35% of the fund’s assets;

> Pension funds up to 40% of the total asset value, 10% per one issuer or issuer’s Group.

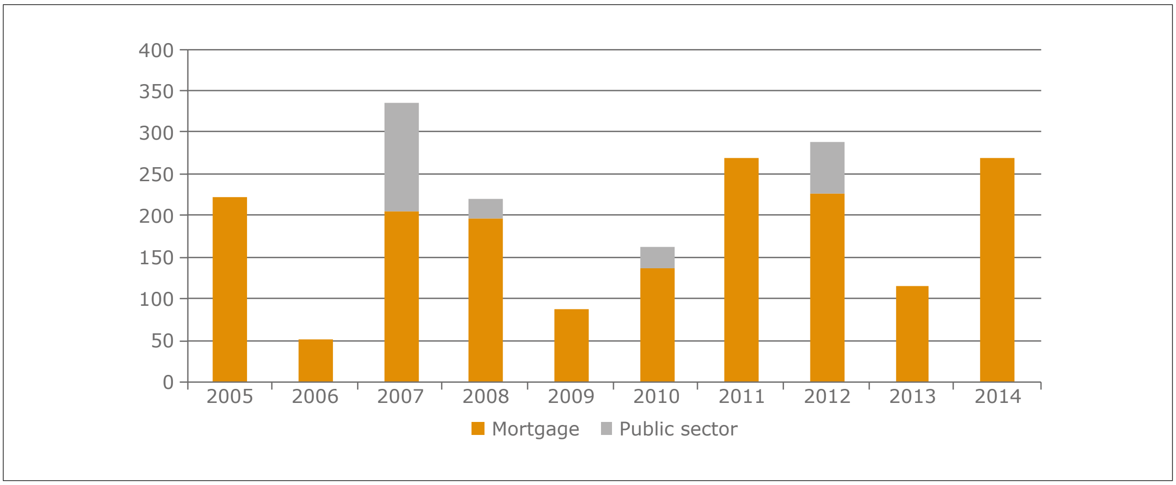
[2] For further information on the UCITS Directive and the Capital Requirements Regulation (CRR) please see: http://ecbc.hypo.org/Content/default.asp?PageID=504#position.

> Figure 1: Covered Bonds Outstanding, 2005-2014, EUR m



Source: EMF-ECBC

> Figure 2: Covered Bonds Issuance, 2005-2014, EUR m



Source: EMF-ECBC

Issuers: Pekao Bank Hipoteczny S.A. and mBank Hipoteczny S.A.

ECBC Covered Bond Comparative Database: http://ecbc.eu/framework/77/Polish_Covered_Bonds.

3.25 PORTUGAL

By Alda Pereira, Caixa Geral de Depósitos

I. FRAMEWORK

In Portugal, the legislation on covered bonds (*Obrigações Hipotecárias* and *Obrigações Sobre o Sector Público*) is regulated by Decree-law no. 59/2006 of 20 March 2006 and complemented by secondary legislation – Notices and Regulatory Instruments of the Central Bank (*Avisos e Instruções*), which address issues such as the segregation of assets from the insolvent estate in case of issuer insolvency, the compliance of asset and liability matching and mortgage valuation methodology.

The exemption of withholding tax for non-resident investors for bonds issued by Portuguese entities was passed in November 2005 (Decree Law n. º 193/2005).

II. STRUCTURE OF THE ISSUER

Obrigações Hipotecárias (OH) and *Obrigações Sector Público* may be issued by credit institutions legally authorised to grant credits guaranteed by mortgages on real estate and with own funds amounting to no less than EUR 7,5 m. These credit institutions are either universal banks or special issuance entities – Mortgage Credit Institutions (MCI).

If the issuer is a universal bank, a direct issue will take place with the cover assets remaining on its balance sheet. If the issuer is a MCI, its authorised business activity is restricted to the granting and acquisition of credits guaranteed by a mortgage or loans of the central government, regional or local authorities or credits guaranteed by these entities. They may also undertake the management of assets that have been repossessed from credits in default, and undertake the activities necessary to obtain additional liquidity and adequately manage the pool.

Assuming the MCI is wholly-owned, the asset originator then transfers the cover assets to this institution and the assets and liabilities will consolidate on the originator’s balance sheet. However, it is also possible for the MCI to have multiple owners and, in this case, the assets may or may not consolidate back to the originator.

Considering the MCI has a limited business activity which only makes sense within the context of covered bond issuance, one could expect the MCI to be a 100% owned subsidiary and, as such, act as a complement to the originator’s business and funding activity. In this sense, it seems reasonable to expect that it could draw on the parent company’s resources to operate.

However, the Bank of Portugal will always determine, on a case by case basis, the necessary conditions that must be met in order to set up an MCI.

III. COVER ASSETS

Credit mortgage loans are eligible as collateral for mortgage covered bonds i.e. credits guaranteed by first ranking mortgage loans. Second mortgage loans can be assigned to the pool if the first mortgage loan was previously assigned as well – therefore both loans are attached to the same property, provided that the total amount of these loans does not exceed the maximum Loan to Value (LTV) level permitted.

Public sector assets are eligible as collateral for public sector bonds i.e. loans granted to the central governments, regional or local authorities or guaranteed by these entities.

The Law specifies that the registration of the assets must assure mortgage credit and public sector segregation. This means that separated pools will have to be set up.

Substitution assets (up to 20%) can be included in the pool:

- Deposits with the Bank of Portugal in cash, government bonds or other eligible bonds (ECB Tier 1 assets)[1];
- Deposits in other credit institutions rated at least "A-";
- Other low risk and high quality assets – if necessary, to be defined by the Bank of Portugal.

Even though the Portuguese Covered Bonds Decree Law allows for substitution assets up to a limit of 20% of the pool, Bank of Portugal's regulation establishes that the pool can only trade with credit institutions qualifying for credit quality assessment step 1 and that the aggregate risk positions cannot exceed 15% of the aggregate nominal value of the outstanding covered bonds or public sector covered bonds (with the exception of those positions with a residual maturity of 100 days or less), thus complying with what is establish by Article 129(1)(c) of the Capital Requirements Regulation (CRR).

The geographical scope of eligible assets is restricted to loans guaranteed by first lien mortgages on property located in the European Union (EU) or loans granted to the central governments and regional or local authorities located in an EU member state.

Derivative contracts are permitted in the cover pool for hedging purposes, namely to mitigate interest rate, exchange rate and liquidity risks. The transactions involving derivatives, must be executed in a regulated market of a Member State of the European Union, in a legally established exchange of a full member of the OECD, or entered into with a counterparty that must be a credit institution rated "A-" or above. The legal documentation (agreement between the parties) should be standardised, however this will have to safeguard the preferential claim for the counterparty. If the currency of the issue is not in EUR, the use of exchange rate derivative contracts is mandatory in order to hedge the inherent risk of the issue.

The cover pool is dynamic while the originator is solvent and issuers are required to maintain a record of all the assets in the cover pool, including derivatives contracts.

IV. VALUATION AND LTV CRITERIA

The value of the mortgaged asset[2] is the commercial value of the real estate, considering:

- Sustainable characteristics over the long term;
- Pricing under normal market conditions;
- The peculiarities of the local market; and
- The current and alternative uses given to the mortgage asset.

The value of the mortgage asset ascertained by the issuer cannot be superior to its market value, which is the price that the object could be sold at the time the appraisal is made. This assumes that the real estate is placed on sale and that market conditions allow for a regular transmission of the mortgaged asset within an adequate timing.

The property appraisal should be carried out by an independent appraisal specialist, previous to the respective mortgage credits being assigned to the covered bond pool.

Appraisals already carried out by a property appraisal expert are also accepted as long as the following conditions have been met:

- Appraisals have been carried out by an expert independently of the credit analysis and decision process of the bank;

[1] Notice n.º 6/2006.

[2] Notice n.º 5/2006.

> Appraisals have been documented in a written report that includes, in a clear and rigorous form, the elements that allow for an understanding of the analysis conducted and the conclusions arrived at by the expert;

> The property was appraised from a market value perspective or a property value perspective as defined in the law;

> There is no evidence that the property appraisal, arrived at from the perspective above mentioned, was overvalued at the time the loan was assigned to the covered bond pool.

The value of the mortgaged property must be checked by the institution on a periodic basis, at least every three years for residential mortgages and at least once a year for commercial properties. More frequent checks must be carried out if market conditions are prone to significant changes.

In order to check the value of the mortgaged property or to identify those properties that require periodic appraisal by an expert, the institution may use indices or accepted statistical methods that it considers appropriate. When indices or statistical methods are employed, the credit institution must submit to the Bank of Portugal a report detailing the foundations for the use of those indices or statistical methods along with an opinion on their adequacy by an external independent appraisal specialist.

Property appraisal must be revised by an expert whenever there is relevant information that indicates that a substantial reduction of the asset value has occurred or that the asset value relative to the general trend of the market has declined significantly.

For loans that exceed 5% of the institutions' own funds or exceed EUR 500,000 for residential mortgages and EUR 1 m for commercial mortgages, the appraisal must be carried out at least every three years.

Revision of the value of an asset must be documented by the credit institution, in a clear and rigorous way, namely a description of the criteria and frequency of such a revision.

The property appraisal should be carried out by an independent appraisal specialist, with qualifications, competency and professional experience to perform this function.

The appraisal specialist is deemed not to be independent if he is in a situation susceptible of affecting his unbiased opinion, namely if he has any specific interest in the real estate being appraised or any relationship – commercial or personal – with the debtor, or if his compensation is dependent on the appraisal value of the property. The appraisal specialist may belong to the institution; however, he must have independence from the credit analysis and decision process.

The selection of the appraisal specialist by the institution must assure both diversification and rotation, and the credit institution has to maintain an updated list of the selected appraisal specialists, identifying the criteria justifying their selection and the real estate appraised by each specialist.

This list should be sent to the Bank of Portugal until the end of January of each year, reporting up to 31 December of the previous year, and indicate any changes from the last report. If there are any doubts on the performance of the appraisal specialist, the Bank of Portugal can refuse to accept the valuations, demanding the appointment of another appraisal specialist by the credit institution.

When choosing the appropriate method, the appraisal specialists should consider the specific characteristics of the real estate and its local market. The appraisal of the real estate performed by the specialist should take the form of a written report and include all the elements that allow for an understanding of the analysis carried out and conclusions arrived at.

The maximum loan to value accepted for assets to be eligible into the pool is 80% for residential mortgages and 60% for commercial mortgages loans.

V. ASSET – LIABILITY MANAGEMENT

There are various asset and liability matching requirements established in the decree-law:

> The global nominal value of the outstanding mortgage bonds cannot exceed 95% of the global value of mortgage credits and other assets at any point in time assigned to the bonds (i.e., mandatory overcollateralisation of 5.2632%);

> The average maturity of outstanding mortgage bonds can never exceed the average life of the mortgage credits and substitution assets assigned to the issues;

> The total amount of interest to be paid by the mortgage bonds shall not exceed, at any point in time, the amount of interest to be collected from mortgage credits and other assets assigned to the bonds – cash flows from the cover pool must all be sufficient to meet all scheduled payments due to covered bond holders.

The law also promotes a sound cover pool management by allowing the issuer to apply the funds (for example, funds received from early repayment) to other assets and assign new mortgages to the pool. This option allows issuers to avoid potential cash-flow mismatches. It is also possible for issuers to establish a credit facility to provide for liquidity. This credit facility counterparty is required to have a minimum credit rating of "A-".

Issuers may use derivatives contracts to hedge the interest and exchange rate and liquidity risks. The derivatives are included in the cover pool and derivative counterparties – who also benefit from preferential claim – have to be rated "A-"or above.

If the limits defined in the Decree Law are exceeded, the issuer shall immediately resolve this situation by assigning new mortgage credits, purchasing outstanding bonds in the secondary market and/or assigning other eligible assets. These will, in turn, be exclusively assigned to the debt service of the bond.

Regarding these matters, the secondary legislation[3] determines the application of the following criteria:

> Loans must be accounted according to their outstanding principal, including matured interest;

> Deposits shall be accounted according to their amount including accrued interest;

> Interests eligible for Eurosystem credit transactions shall be accounted according to the value resulting from the rules regarding valuation margins defined by the Eurosystem or, if lower, according to its nominal value, including accrued interest;

> Covered bonds and public sector covered bonds shall be accounted according to the corresponding outstanding principal, including accrued interest.

Interest rate or FX derivatives must be accounted in accordance with their market value and in the event that the corresponding loans and other substitute assets are denominated in different currencies, the issuer must ensure hedging of the relevant currency risk, and the reference exchange rates published by the European Central Bank shall be used for this purpose.

Single name risk is also addressed. The aggregate in risk positions with credit institutions – excluding those with a residual maturity date of 100 days or less – cannot exceed 15% of the aggregate nominal value of the covered bonds or public sector covered bonds outstanding.

The net present value of the liabilities arising from the issuance of mortgages covered bonds or public sector covered bonds cannot be higher than the net present value of the portfolio allocated to such bonds, taking into account any derivative instruments put in place. The ratio established shall be able to comply even when 200 basis points parallel movements of the curve are considered.

[3] Notice n.º 6/2006.

Each issuer must deliver in writing the specific and individual policies in written form for risk management, namely exchange risk, liquidity risk, interest rate risk, counterparty risk and operational risk and any other procedures aimed at ensuring compliance with the applicable regulatory regime and with any devised risk limitation policies set by the issuer.

The Bank of Portugal may also make use of its regulatory role to require additional steps by the issuers to meet with all the asset-liability criteria that it sets out.

VI. TRANSPARENCY

In order to provide consistent data and transparency for their issues, thus complying with Article 129 (7)(b) CRR, Portuguese covered bond issuers have developed a Common National Transparency Template based on the CBIC Template in order to ensure standardisation and comparability of the data provided by its covered bond investor reports. The Template can be found at the Covered Bond Label website.[4]

These investor reports are published on each bank's website, encompassing specific, relevant and detailed information on the Portuguese covered bonds and the cover pools and are updated on a quarterly basis. Key concepts explanations are available for a better comprehension.

Should investors require additional financial information they deemed relevant on the Bank's consolidated accounts or Groups Balance Sheet, they can obtain it on the respective website or directly by contacting the issuers.

VII. COVER POOL MONITOR AND BANKING SUPERVISION

The Board of the issuer will appoint an independent auditor who must be registered with the Portuguese Securities Commission, with the task of defending the interests of the bondholders and of verifying the compliance to applicable legal and regulatory guidelines. An annual report must be published. The Bank of Portugal will review its content and may make use of its regulatory role to request additional information[5].

In the law, there are no specific rules on the cover pool monitor's responsibility. General rules on civil and contractual responsibility apply. The cover pool monitor will only be liable in case it does not comply with rules applicable to its activity or with its contractual obligations. If the cover pool monitor has complied with all its obligations, it will not be liable in case the issuer has not respected the applicable regulation.

Also, a bondholders' joint representative – common to all mortgages or public bond issues – is to be appointed by the Board of Directors of the issuer in order to represent the interest of the bondholders and supervise the cover pool.

The Bank of Portugal and the Portuguese Securities Commission (CMVM) are responsible for banking and capital markets supervision. The law grants powers to the Bank of Portugal to regulate and supervise the issuers of covered bonds, so they must comply with the requirements of the law and all applicable regulations. Non-compliance by the issuer could imply the application of fines and other sanctions and, ultimately (in a worst case scenario), could determine the revocation of the issuer's licence.

Additionally, the Bank of Portugal has been granted powers to control compliance of the applicable rules for as long as the bonds remain outstanding, namely it may:

> Refuse asset valuations made by a valuation's expert if it has doubts concerning its performance, and demand to the issuer its replacement;

> Require new asset valuations by different experts; and

> Ask for clarifications or additional documents concerning all reports required and received.

[4] https://www.coveredbondlabel.com/issuers/national-information-detail/19/.

[5] Regulatory Instrument n.º 13/2006.

VIII. SEGREGATION OF COVER ASSETS AND BANKRUPTCY REMOTENESS OF COVERED BONDS

Preferential status for Portuguese covered bonds holders and bankruptcy remoteness

Holders of covered bonds benefit from special preferential claim over the assets assigned to the issue, with precedence over any other creditors – the covered bond law supersedes the general bankruptcy regulation – for the redemption of principal and payment of interest.

The mortgages that guarantee these credits prevail over any real estate preferential claims. The derivatives contracts are part of the pool and derivatives counterparties rank pari passu with bondholders in terms of preferential claim over the assets in the pool, and consequently, their contracts are not expected to be called in case of insolvency of the originator.

Despite the absence of a direct link between the cover assets and the outstanding covered bond issuance, there is a legal provision that links the cover pool to the payment of capital and interest on the covered bonds thus rendering covered bonds direct, unconditional obligations of the issuer. The issuer of covered bonds holds the claims on the cover assets and these, in turn, will guarantee the covered bonds until all payments due to bondholders have been met.

If the issuer becomes insolvent, cover assets form a separate legal estate – a pool that is to be administered in favour of the covered bondholders, and consequently there is no automatic acceleration of the mortgage bonds.

However, bondholders may convene a bondholders' assembly and may decide by a majority of 2/3 with regard to the outstanding bond volume to call the mortgage bonds, in which case, the administrator shall provide for the liquidation of the estate assigned to the issues and thereafter the payment of creditors in accordance with the provisions defined in the decree-law.

If the cover assets are not sufficient for the covered bonds, bondholders and derivative counterparties will rank pari passu with any common creditors of the issuer in relation to all other assets of the issuer (not included in the cover pool), after all guaranteed and privileged creditors have been duly paid up, for the payment of the remaining debt due to them.

Asset segregation

The assets – mortgages loans or public sector loans and substitute assets – and derivative contracts assigned to the issues are held by the issuer in separated accounts – cover register – and can be identified under a codified form. This information is deposited in the Bank of Portugal in the form of a code key. The Bank of Portugal regulates the terms and conditions by which the bondholders will have access to such key in case of default[6].

The legal effect of registration is to segregate those assets from the insolvent estate over which bondholders will have a special claim in case of insolvency/bankruptcy. In this situation the assets pledged to one or more issues of mortgage bonds will be separated from the insolvent estate for the purpose of its autonomous management until full payments due to the bondholders have been met. Despite this, the law stipulates that timely payments of interest and reimbursements should continue. In that way, cover assets form a separate legal estate, a pool administered in favour of the covered bondholders.

In an insolvency situation of the issuer two situations may occur:

> The issuer voluntarily assumes that it is insolvent and will present a project to the Bank of Portugal pursuant to article 35-A of the Credit Institutions General Regime, containing the identification of the credit institution that will be appointed to manage the cover pool, together with the terms under which those services will be rendered;

[6] Notice n.º8/2006.

> The revocation of the authorisation of the issuer with outstanding covered bonds or public sector covered bonds takes place, and the Bank of Portugal shall appoint a credit institution[7] to undertake the management of the cover pool.

The cover pool will be managed autonomously by this credit institution, which should prepare, immediately upon initiating its management, an opening balance sheet in relation to each autonomous portfolio and relevant bonds, supplemented by the necessary explanatory notes and should perform all acts and deals necessary for a sound management of the loan portfolio and its guarantees with the aim of ensuring a timely payment on the covered bonds, including selling credits, assuring their servicing all administrative procedures pertaining to these credits, the relationship with the debtors, and all modifying and extinguishing acts relating to their guarantees and must carry out and keep updated a registry, in off-balance sheet accounts, the details of the cover pool, in the terms set forth in the Decree-law No. 59/2006.

IX. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

The legislation when taken together with the practices, processes and procedures across the industry should fall within the criteria of Article 129 CRR. Portuguese covered bonds meet the requirements of Article 129 CRR.

According to the Capital Requirements Directive (CRD) IV, a 20% risk-weighting should be applied for covered bonds issued within the scope of the Portuguese jurisdiction.[8] The risk-weighting of derivatives that are included in the cover pool will be 20%. Investment funds can invest a maximum of 25% of their own funds in a single issuer's covered bonds.

X. ADDITIONAL INFORMATION

Developments in the Portuguese covered bond market

During 2014, financial markets remained relatively stable as low inflation and weak economic growth favored risk aversion, a sentiment only slightly broken in the beginning of the year by a reduction of pace of the Federal Reserve's asset purchase program and later in October by a sharp drop in oil prices.

Emerging markets were the most affected, particularly those with large internal and external imbalances. Consequently, at the end of the year, there was a slight increase in risk aversion as expectations of weak economic growth were sustained, leading to a decrease in the yields in public debt of the more developed economies.

In light of this situation, the European Central Bank aimed to support the Euro area economies by promoting the necessary macroeconomic adjustment while allowing for stability in sovereign debt prices and providing sufficient liquidity to prevent the deterioration of funding conditions in these economies. Its strategy was focused on new monetary stimuli, through the cut of official interest rates, the introduction of measures to boost lending and a new asset purchase program.

The Euro Area also enjoyed significant reduction in sovereign debt yields as investors' demand for returns became one of the market's main supporting factors as a reaction to historical lows in long term interest rates and spread compression.

In Germany, the 10 years rate decreased by 138.8 bps to 0.54% and the 2 years rate fell 31.1 bps having, in this case, closed the year at a negative value (-0.098%) and a historical minimum.

In European peripheral countries, yields also registered a sharp reduction following the trend of the preceding year, with spreads to the German benchmark narrowing. Greece was the only exception as uncertainty regard-

[7] Designated Credit Institution.

[8] Please click on the following link for further information on the UCITS Directive and the Capital Requirements Regulation (CRR): http://ecbc.hypo.org/Content/default.asp?PageID=504#position.

ing the conclusion of its Assistance Program led to a huge increase on the differentials to Germany. However, this situation has not become contagious to other countries under adjustment programs where the differential remained relatively stable.

This favorable evolution of the risk premium on peripheral issuers was consistent throughout the year and issuers benefited from a favorable environment to return to economic growth further assisted by support from the European Central Bank.

Consequently, there was a fall in sovereign debt yields in Ireland, Italy, Portugal and Spain, also partly derived from the reduction of imbalances in public and external accounts and the strengthening of European governance mechanisms.

The improving economic and financial situation in Portugal enabled a reduction of financing costs in capital markets, which together with the greater liquidity of financial institutions led to a reduction of interest rates. Also, on May 18th 2014, Portugal left the EU bailout mechanism without additional need for support and with its latest issuance of a 10-year bond successfully completed with a low rate of 3.59%.

During 2014, on the European periphery, Portugal was the country with the largest reduction in its 10 year rate which fell 344 bps to 2.69%, and the 10 year bonds in Italy and Spain also obtained notable reductions of 224 bps to 1.89% and 254 bps to 1.61%, respectively.

Portugal witnessed a reduction of risk premium for the third consecutive year on its sovereign debt, a 205.5 bps narrowing of the spread in comparison to German debt. For the 2 year maturity, the fall in the Portuguese yield was 290 bps with a spread compression of 259.5 bps.

From January to May 2015 the Portuguese 10 year benchmark yield fell 486 bps achieving a historical minimum of 1.56% as of March 2015.

The primary market outperformed expectations with investors' demand posting significant amounts of debt issues from both financial and non-financial entities. In particular, in 2014, the non-financial segment saw a 33.3% annual increase of issuances when compared with the previous year.

Progression in terms of the integration of the European financial system, particularly regarding the asset quality review and the stress tests, in the sphere of the single supervisory mechanism provided additional market backing.

The context of monetary stimuli, particularly in Europe, the evidence of a strong growth in the US and forecast of an acceleration in global economic activity in 2015, may create a favourable scenario for the private debt market and consequent reduction of risk premium.

Under a stabilizing market environment, the Portuguese Covered Bond market reacted positively and investors revealed a tendency to extend the duration of their portfolios and increase the purchase of assets showing a low risk assumption.

Portuguese covered bonds secondary market showed a very good performance. Mention should be made of the performance of yields in the 5 years outstanding maturity of the CGD issue, which decreased from 3.699% on the 2nd of January 2014 to 0.861% and 0.503% respectively on the 31st of December 2014 and the 19th of May 2015. The 7 year maturity issue also declined from 1.096% on the 22nd of January 2014 to 0.776% in the 19th of May 2015.

Benefiting from better funding conditions than in the recent past Caixa Geral de Depósitos ("CGD") launched in January 2015 a €1 billion 7 years covered bond issue with a coupon of 1%. This issue was well received by the market, with final demand exceeding €1.4 billion at a final spread of 64 basis points over middle swap – corresponding to a reoffer yield of 1.099% significantly lower than that achieved 2 years before (minus 124 and minus 221 basis points when compared respectively to the January 2013 and 2014 issues), thus confirming investor's interest in Portuguese covered bonds and in CGD's credit. In terms of distribution, demand was mainly driven by non-domestic investors taking 62% of the allocated bonds (excluding the Euro-system Order). German and Austrian orders represented 25% of total allocations. In terms of investor type, Fund Managers took 53%.

Also, Banco Santander Totta successfully tapped the market in 2014, in April with a €1 billion 3 years issue with a coupon of 1.5% and in June with a € 750 million 5 years covered bond with a coupon of 1.625%, with a reoffer price of 88 bps and 93 bps over middle swap respectively. International demand represented 97% and 90% of the total respectively, the transactions were mainly driven by international investors with a great geographic diversification and including a considerable participation of real money accounts.

During 2014 there was an improvement in financing conditions for banks along with reduced risk in the housing market and greater ability of consumers to ensure their debt service. However, interest rates for housing related business remained high when compared to the average levels preceding the financial crisis. Additionally, real interest rates, although lower in 2014, are still higher than the average record since the inception of the euro area, signaling the existence of restrictive financing conditions. As such, according to the Bank of Portugal, production of new mortgage loans remained low despite the existing signs of some improvement in market perspectives which is the justification for reduced new covered bond issuance. The perspective of economic growth and higher employment levels combined with better conditions in the financial markets where yields are evolving to more attractive levels, could create the conditions for increased new mortgage lending and consequently, the need for increasing covered bond issuance.

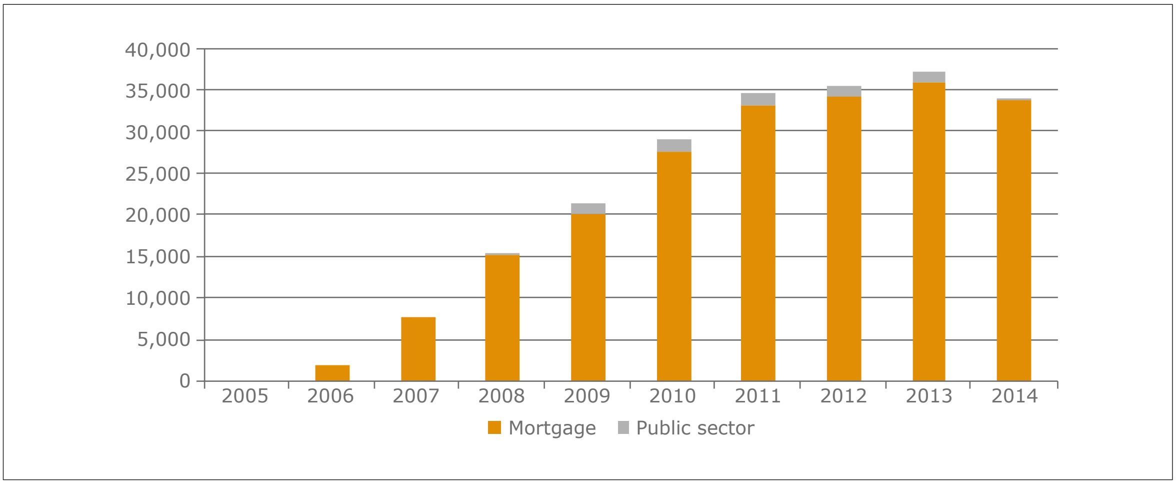
Also, in 2014 Portugal's housing market begun slowly to recover and house prices started to rise again. According to figures released by Portuguese Statistics (INE) the average housing appraisal rose 1.81% in March 2015 (1.50% in real terms) when compared with the value registered in March 2014. The interest rate on housing loans continued its downward trend since August 2014, standing at 1.314% in March 2015. Also, in the first quarter of 2015, the construction sector registered signs of improvement with many indicators showing a favorable trend, like the decrease in unemployment and insolvencies and a rise of new building licenses.

Non-performing mortgage loan levels continued to rise in 2014. According to statistics from Bank of Portugal, the NPL level peaked at 2.45 in February 2015, still a low level compared to other loan categories such as consumer loans where NPL levels have reached 10.83%.

For these low levels of mortgage NPL contributed not only better conditions in the labor market, with the unemployment rate gradually declining – it stood at 13.5% as of March 2015 – low inflation and the ECB's very low interest rate policy which helped keep Euribor rates at an historical low level, since this is the most used index rate for variable mortgage loans, representing more than 90% of mortgage loans granted by Portuguese banks.

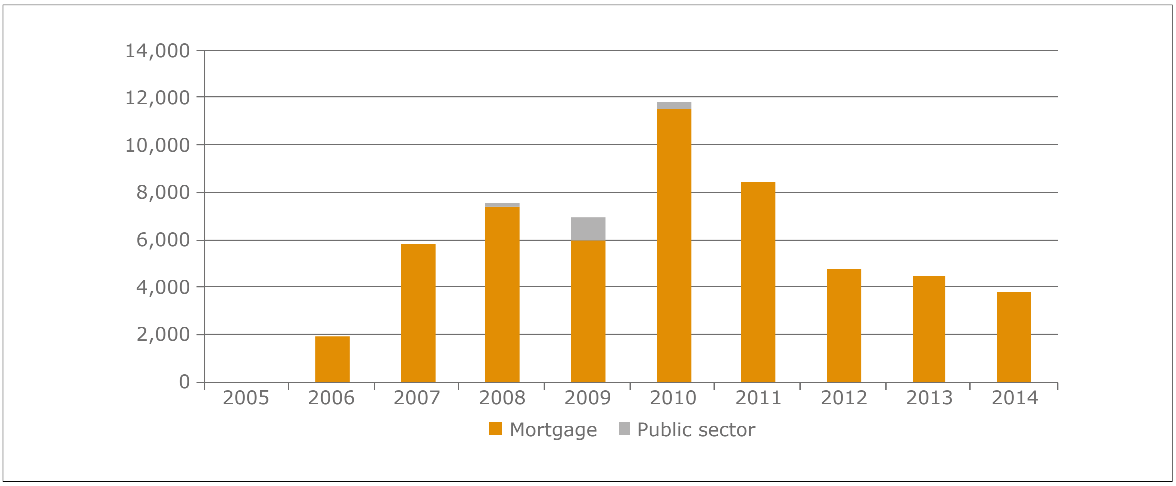
By December 2014, both *Obrigações Hipotecárias* and *Obrigações sobre o Sector Público* combined have achieved an outstanding amount of € 34.1 billion with a residual weighted average tenor of 3.2 years.

> FIGURE 1: COVERED BONDS OUTSTANDING, 2005-2014, EUR M



Source: EMF-ECBC

> FIGURE 2: COVERED BONDS ISSUANCE, 2005-2014, EUR M



Source: EMF-ECBC

Issuers: Banco Comercial Português, Novo Banco, Banco de Investimento Imobiliário, Banco Português de Investimento, Caixa Económica Montepio Geral, Caixa Geral de Depositos, Banco Santander Totta, Banco Popular Portugal and Banco Internacional do Funchal.

ECBC Covered Bond Comparative Database: http://ecbc.eu/framework/38/Public_Sector_CB_%28Obriga%C3%A7%C3%B5es_sobre_o_Sector_P%C3%BAblico%29 and http://ecbc.eu/framework/39/Mortgage_CB_%28Obriga%C3%A7%C3%B5es_Hipotec%C3%A1rias%29.

COVERED BOND · L A B E L · : BPI Mortgage Cover Pool; BCP Residential Mortgages; Novo Banco Mortgage Cover Pool; Banco Santander Totta S.A.; Caixa Economica Montepio Geral; Caixa Geral de Depositos Mortgage Cover Pool.

3.26 ROMANIA

By Irina Neacsu, Banca Comerciala Carpatica, in the name of Romanian Banking Association,
and Adrian Sacalschi, FHB Bank

I. FRAMEWORK

In Romania, the legal basis for Covered Bond issuance is the Mortgage Bonds Law from March 2006. This law supersedes the general bankruptcy regulation.

The legal framework for covered bonds is currently under revision in Romania. Below we will refer also to some important features which are under discussion with the Romanian supervisory authorities for being amended.

Since the implementation of the existing Mortgage Bonds Law no covered bonds have been issued by a local issuer.

II. STRUCTURE OF THE ISSUER

The issuer can only be a credit institution (as defined by Romanian Banking Law, which is in line with the EU legislation). Therefore, all commercial or mortgage banks may be issuers and no other special covered bond license is required.

According to the proposed Covered Bond law draft, the issuer can be a credit institution as defined in Article 4 para (1) of the EU Regulation 575/2013. The Central Bank is supervising the covered bond issuance activity, for fulfilment of the prudential requirements.

Mortgage banks are credit institutions, but their licensing is limited since this type of credit institutions are not allowed to receive deposits. The National Bank has not yet issued the set of applicable regulations for mortgage banks. Up to date no mortgage bank as such is incorporated under Romanian Law.

Pursuant to the Mortgage Bonds Law, the issuer holds the assets on its balance sheet. The covered bond issuer holds the ownership title over the portfolio. A direct legal link between single cover assets and covered bonds does not exist. All obligations from bonds are obligations of the issuing bank as a whole. However, under the current law there is a legal link between each bond issue and its pool of cover assets. In the event of insolvency, the cover pool is segregated by law from the general insolvency estate and is reserved for the claims of holders of the specific bond issue.

Assets servicing may be outsourced, but for covered bonds it is expressly regulated only in case of the issuer's bankruptcy.

The covered bonds are direct and unconditional obligations of the issuer. The claims of the holders of covered bonds are secured by a first rank security interest over the cover assets, which are segregated in bankruptcy. Each bond issue is guaranteed by a distinct pool of assets. In the event of bankruptcy, the bonds holders in a specific issue will have first priority over the pool of assets dedicated to the specific issue.

The proposed Covered Bond law imposes the issuers to obtain the Central Bank approval for covered bond issuance prior to launching such a covered bond issue. Such approval/authorization is valid for one year and it will be withdraw by the Central Bank if the issuer is not launching in one year period any covered bond issue.

This legislative provision regarding separate cover pools for each covered bond issue will be set aside in the amended Romanian covered bond legal framework, which is currently under preparation in Romania.

III. COVER ASSETS

In the case of covered bonds structured under the Mortgage Bonds Law, only mortgage loans (i.e. residential or commercial mortgage loans) can be included in the cover pool. The cover pool could be replenished with other mortgage loans if some of the pledged loans don't fulfil the eligibility criteria anymore. Other eligible assets (besides mortgage loans) will only be used for supplementing the cover pool if the issuer has no other mortgage loans that could be used for such a purpose. The list of these other eligible assets which can be included in a cover pool is to be established by the National Bank.

In terms of derivatives allowed to be included in the cover pool, no special provisions are contained in this respect in the Mortgage Bonds Law. However, the National Bank is entitled to regulate the categories of eligible assets that can be used for supplementing the cover pool in case the issuer has no other mortgage loans. The only restriction in this respect imposed by the Mortgage Bonds Law stipulates that the general maximum ratio allowed for supplementing the portfolio and the substitution of the mortgage loans in a cover pool with eligible assets may not exceed 20% of the portfolio value.

The proposed covered bond law draft stipulates that the mortgage loans must fulfil several eligibility or performance criteria imposed by the Mortgage Bonds Law in order to be included in the cover pool:

- *The pool is homogenous comprising of only one type of mortgage loan according to its investment destination;*
- *The weighted average of the maturities of the mortgage loans included in the cover pool securing an issue is higher than the maturity of the mortgage bonds secured by such a cover pool; the weighted average of maturities shall be calculated by weighting the outstanding life time of the loans included in the cover pool with the nominal value of the loan as of the date of issue;*
- *Net present value of the mortgage receivables must exceed the net present value of covered bond debts, minimum overcollateralization of 2% is required;*
- *Central Bank will issue secondary regulations to set up:*
  - *the rules for single debtor exposure limit;*
  - *% of the cover pool assets consisting in mortgages on properties without constructions out of the total cover pool value;*
  - *asset encumbrances limit.*
- *Only 60% of the mortgage reference value is considered in the cover pool;*
- *Mandatory 180 days coverage of the negative gap between the mortgage cash flow and covered bond cash flow (coverage of such difference with financial assets);*
- *Each mortgage loan in the cover pool meets the general eligibility criteria provided by this law and the performing criteria established through the prospectus;*
- *The nominal value of a mortgage loan does not to exceed, in case of a residential mortgage loan, 80% of the reference value of the immovable asset over which the security interest was created and, in case of a other mortgage loans, 60% of the reference value of the immovable asset over which the security interest was created (exceptions are permitted for special programmes, like "First Housing Programme");*
- *The amount representing the principal granted through a mortgage loan agreement has been fully disbursed to the beneficiary;*
- *The receivables deriving from the mortgage loans are not subject to a security interest in favor of any other person;*
- *The mortgage loan must not register delayed payments exceeding 61 days; and*
- *The real estate over which a security has been created for the reimbursement of the mortgage loan is insured against all risks for an amount equal with the reference value of the immovable established on the date of the mortgage agreement.*

In terms of geographical coverage, the sole restriction imposed under the Mortgage Bonds Law provides that, in order to be included in the cover pool, the mortgage loans should be granted for real estate investments on the territory of Romania or on the territory of member states of the European Union or the European Economic Area.

The current Mortgage Bonds Law generally stipulates that the cover pool is static. The replacement of the mortgage loans included in the cover pool is prescribed as an obligation only when certain mortgage loans no longer comply with the eligibility criteria, have become non-performing in the meaning of this law or determine the reduction of the weighted average of the maturities of the mortgage loans included in the cover pool, of the value of the mortgage loans included in the pool or of the interest amount, according to the limits provided by law.

In the amended Romanian covered bond legal framework it is intended to have only ***one cover pool*** *(****a mortgage cover pool*** *– comprising of eligible mortgage and housing loans), which will be dynamic.*

Regarding the **disclosure requirements**, detailed information concerning the assets included in the cover pool has to be provided in the offering circular, such as: the value of the mortgage loans included in the cover pool; the reference value of the collateral created for the reimbursement of the mortgage loans as established at the conclusion of the collateral agreement against the nominal value of the issue; the interest coverage provided by the cover pool; geographical dispersion of the mortgage loans, maturity, interest, interest computational method and payment schedule as well as prepayment conditions under the respective mortgage loans.

The internal cover register shall contain detailed information on the cover pool and a separate section for registering the substitute assets included in the cover pool. The internal cover register shall be kept and filled in by the issuer with respect to any amendments or changes to the data since the initial registration.

IV. VALUATION AND LTV CRITERIA

Property valuation is regulated and is required to be undertaken by an authorized real estate appraiser. The reference for a property value is considered to be the market value as opposed to the mortgage lending value. Details about the valuation process and the qualifications of valuers are regulated by the Romanian Association of Evaluators (ANEVAR). The legal framework does not incorporate any special monitoring requirement.

The Mortgage Bonds Law stipulates limits for maximum LTVs on residential loans or other mortgage loans at 80% and 60%, respectively. *These are absolute LTVs refer to the loans granted. No provision is made regarding a relative limit.*

V. ASSET – LIABILITY MANAGEMENT

The Mortgage Bonds Law stipulates that the net present value of the outstanding bonds must be covered at all times by the net present value of the assets and that the weighted average term to maturity of the assets should be higher than the bonds' maturity. *The draft of the amended covered bonds law stipulates a minimum 2% overcollateralization.*

VI. TRANSPARENCY

In the current Romanian legal framework on mortgage covered bonds there are no provisions on transparency.

Under the amended legislation issuers of covered bonds would be obliged to prepare and publish quarterly reports on the total volume of the issued covered bonds and the structure of the cover pool, including the nominal value of the receivables in the pool, their residual value and the structure of maturities of the receivables in the pool.

The supervisory authorities would be entitled to draft regulations regarding the content, the terms and publication of the quarterly reports.

VII. COVER POOL MONITOR AND BANKING SUPERVISION

Under the Mortgage Bonds Law, the activity of a mortgage bond issuer is monitored by the Financial Supervisory Authority (ASF) and the National Bank (BNR). For mortgage bonds, the law provides for the mandatory appointment of an agent. The agents have to be authorised jointly by the National Securities Commission and by the National Bank. Initially, the agent shall be appointed by the issuer from a list of agents, approved by the National Bank (mandatory pre-requisite for the issuance of mortgage bonds). Upon subscription of the mortgage bonds by the investors, the revocation/appointment of the agent shall be made exclusively by the general meeting of bondholders.

The agent's main role is to monitor the cover pool on behalf of the bondholders. Its monitoring obligations shall be performed on a monthly basis, based on the synthetic documentation provided by the issuer. The agent has to observe issuer's compliance with the law and prospectus requirements. Based on the documentation provided by the issuer, the agent shall issue a certificate attesting the issuer's compliance with the provisions of the law and with the offering curricular regarding the cover pool structure. The agent shall be jointly and severally liable towards the bondholders with the issuer, with the financial investment services company handling the sale and with the issuer's financial auditor for the damages caused by non-fulfilment of several duties provided for under the law (including the obligation to monitor the issuer's compliance with the requirements related to the cover pool).

The draft of the covered bond law stipulates that the agent is appointed by the issuer from the list of auditors accepted by the NBR and it is approved by NBR. Also, a representative of the covered bond holders must be appointed by the bondholders in the first covered bond holders meeting, his role being to exercise, on its own name, but on the account of bondholders, the bondholders rights, except the voting rights.

The qualification, role and duties of the agent will be clarified in the amended Romanian covered bond legal framework.

VIII. SEGREGATION OF COVER ASSETS AND BANKRUPTCY REMOTENESS OF COVERED BONDS

A cover register allows for the identification of the cover assets for each issue. The issuer has the obligation to keep a cover register for each mortgage bond issue.

Registration in the cover register reflects the structure and dynamic of the portfolio at any time throughout the life of the issue. The cover register contains information with respect to each mortgage loan included in the cover pool (i.e. type: commercial or residential, beneficiary of the loan, immovable asset over which the security for reimbursement of the mortgage loan has been created, land book number, value of the mortgage loan and reference value of the immovable asset, any other collateral and its nominal value) and substitute assets.

Registration in the cover register triggers an obligation for the issuer to have a security interest, which is registered with the Electronic Archive and covers each and all assets registered in the register. These assets are specifically registered in the accounting books of the issuer and segregated from the estate of the issuer in the event of bankruptcy. The cover register is kept by the issuer and subject to checks by the agent and supervision by the National Bank of Romania.

Asset segregation

By registration of the security interest over the pledged cover assets and the entry into the internal cover register of the mortgage loans or other assets included in the cover pool, such assets are segregated from the other assets of the issuer. The segregation of the cover assets from the insolvent estate of the issuer is thus a consequence of a contractual pledge and the operation of the law.

After the launching of the insolvency proceedings, a special portfolio management company carries out the administration of the cover assets. The appointment of the cover pool manager is made by the general meeting of bondholders.

Impact of insolvency proceedings on covered bonds and derivatives

Mortgage bonds do not automatically accelerate when the issuing institution becomes insolvent, but the bondholders could be obliged to accept payments in advance, with the corresponding recalculation of their rights if the cash-flows in the cover pool allow that.

The amended Romanian covered bond legal framework will clarify the asset segregation provisions, set aside the de facto acceleration provision and will also clarify the regime of derivatives registered in the cover register.

Preferential treatment of covered bond holders

Mortgage bond holders enjoy preferential treatment as the law stipulates the separation of the cover assets from the insolvent issuer's estate.

In the event that the cover assets of a specific issue are not sufficient to cover the payments of that issue, the Mortgage Bonds Law provides for a cross-subsidy principle amongst different issues of cover bonds of the respective issuer if there is a surplus after payment of all the obligations towards the bondholders in a specific issue. If the cover assets are not sufficient, the bondholders have an unsecured claim towards the bankrupt estate for the difference.

A moratorium on the insolvent issuer's estate cannot delay the cash flows from the cover assets and, therefore, endanger the timely payment of covered bond holders.

A special insolvency procedure could be commenced against the cover pool only by the bondholders.

Access to liquidity in case of insolvency

After bankruptcy proceedings are opened, with the appointment of an asset management company as the cover pool administrator, the right to manage and dispose of the recorded assets is transferred to this company by law. Thus, the cover pool manager first has access to the cover assets and collects the cash flows according to their contractual maturity and pays the amounts due by the issuer to the bondholders.

There are no specific regulations expressly addressing the issue of voluntary overcollateralization in insolvency. It may be argued that voluntary overcollateralization is part of the cover pool with all legal consequences regarding segregation in the event of bankruptcy applicable to the respective pool.

The draft of the amended covered bond law stipulates minimum overcollateralization level of 2%.

Sale and transfer of mortgage assets to other issuers

A bankrupt issuer cannot be liquidated until it has assigned the cover pool to another issuer. The portfolio of assets may be sold to other issuers in a transaction concluded after the launching of the bankruptcy proceedings if the liquidator's report provides the sources from which the insolvent issuer may pay in full the amounts due to the bondholders and if the bondholders in each issue (if more than one) have decided in the general meeting of bondholders to accept payment in advance under the terms provided in the liquidator's report.

IX. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

The legislation when taken together with the practices, processes and procedures across the industry should fall within the criteria of Article 129 of the Capital Requirements Regulation (CRR).[1] The covered bonds issued

[1] Please click on the following link for further information on the UCITS Directive and the Capital Requirements Regulation (CRR): http://ecbc.hypo.org/Content/default.asp?PageID=504#position.

under the Mortgage Bonds Law comply with Article 129(1) CRR and fulfil the UCITS 52(4) criteria. The law requires such bonds to be issued by a credit institution, which is subject by law to special public supervision designed to protect bondholders (i.e. supervision by the National Bank of Romania and respectively by the National Securities Commission) and provides coverage by law of the claims attaching to the bonds in the event of failure of the issuer, on a first priority basis for the reimbursement of the principal and payment of the accrued interest.

ECBC Covered Bond Comparative Database: http://www.ecbc.eu/framework/99/Obligatiuni_Ipotecare_-_Mortgage_Covered_Bonds.

3.27 RUSSIA

By Tim Lassen[1], PFP Group Ltd., Representative Office, Moscow

I. FRAMEWORK

This article will give an overview over the current legal framework for mortgage obligations. Legal basis is the Law on Mortgage Securities[2]. This law is supported by rules in the Mortgage Law, the Bankruptcy Law[3], and the Securities Market Law.

In addition the Central Bank of the Russian Federation (CBRF) issued the Mortgage Cover Mandatory Requirements Instruction[4]. The former Federal Financial Markets Service (FSFR) released[5]:

> The Mortgage Cover Determination Order[6],

> A joint order containing (i) the Special Depositor Decree and (ii) the Register Maintenance Rules[7] and

> The Mortgage Cover Administrator/Special Depositor Data Reporting Decree[8].

Further rules are in general regulations of the CBRF as the new "mega regulator"[9] of the financial market[10].

II. STRUCTURE OF THE ISSUER

The Russian Law on Mortgage Securities foresees two types of "mortgage obligations"[11] (Art. 7, sec. 1[12]): obligations[13] issued (i) by a credit organisation (covered bonds) or (ii) by a SPV ("mortgage agent") (MBS)[14].

[1] Special thanks go to the colleagues from AIZhK and Sberbank for proof reading and commenting on this article. An important information source was published earlier this year: Information Agency CBonds/Rusipoteka (publ.): Encyclopedia of Russian Securitization, 3rd ed. Saint Petersburg 2015.

[2] Federal law dated 11 November 2003 No 152-FZ "On Mortgage Securities".

[3] The former Credit Organisations' Bankruptcy Law has as § 4.1 of Chapter IX been integrated into the Bankruptcy Law (pt. 22 of art. 7 of the Federal Law dated 22.12.2014 No. 432-FZ, published SZ, 29.12.2014, No. 52 (part I), item 7543). Of interest is as well, that Federal Law dated 29.12.2014 No. 476-FZ (published SZ, 05.01.2015, No. 1 (part I), item 29) introduced into the Bankruptcy Law rules on the bankruptcy of natural persons. For the – limited – influence on mortgage securities see: Legal Capital Partners: Special overview: Law on bankruptcy of natural persons – Basic regulations and influence on mortgage securities, 18 February 2015 (in Russian).

[4] Instruction of the CBRF dated 31 March 2004, No 112-I "On mandatory requirements for credit organisations, issuing securities with mortgage cover".

[5] Regarding the merger of the FSFR into the CBRF: See below chapter VII.

[6] Order dated on 1 November 2005 No 05-59/pz-n "On confirmation of the Decree on the method of determination of the mortgage cover".

[7] Order dated 01 November 2005 No 05-60/pz-n "On confirmation of the Decree on the activity of the special depositar for the mortgage cover and the Rules of the maintenance of the register of the mortgage cover".

[8] Order dated 15 December 2009 No 09-57/pz-n "On confirmation of the Decree on data reporting of the administrator of the mortgage cover and the Decree on data reporting of the specialised depositor of the mortgage cover".

[9] See ECBC Fact Book 2014, p. 397.

[10] > Instruction of the CBRF dated 03 December 2012 No 139-I „On mandatory requirements for banks"; here following: Instruction CBRF No 139-I/2012.

> Statute on Dislcosure of Information by the Issuers of Issuing Securities (confirmed by the Bank of Russia, 30.12.2014, No. 454-P) (registered by the Ministry of Justice, 12.02.2015, No. 35989; published: Herald (Vestnik) of the Central Bank, No. 18-19, 06.03.2015) (here following: Statute CBRF No. 454-P).

> Statute on Standards for Issues of Securities, Procedure of State Registration of the Issue (Additional Issue) of Issuing Securities, State Registration of Reports on Results of the Issue (Additional Issue) of Issuing Securities and Registration of Securities' Prospectus' (confirmed by the Bank of Russia, 11.08.2014, No. 428-P) (registered by the Ministry of Justice, 09.09.2014, No. 34005; published: Herald (Vestnik) of the Central Bank, No. 89-90, 06.10.2014) (here following: Statute CBRF No. 428-P).

> Instruction of the Bank of Russia dated 27.12.2013 No. 148-I "On the Procedure of the Conduct of the Procedure of the Issue of securities of Credit Organisation on the Territory of the Russian Federation" (registered by the Ministry of Justice, 28.02.2014, No. 31458; published: Herald (Vestnik) of the Central Bank, No. 32-33, 28.03.2014)(here following: Instruction CBRF No. 148-I).

[11] Language of the Law: "Obligations with mortgage cover".

[12] Law citations without link are citations of the Law on Mortgage Securities.

[13] "Housing mortgage obligations" are a special type of mortgage obligations (in Russian "zhilishchnaya obligatsiya s ipotechnym pokrytiem"): Their cover pool consists only of claims, secured by mortgages over housing premises (Art. 3, pt. 5).

[14] Another mortgage security under the Law is the "mortgage participation certificate" (Art. 17 – 31), an instrument similar to investment fund certificates. Due to their different structure in this article we will not look after them.

Obviously the mortgage obligations issued by credit organisations, are oriented on the European covered bond model, those mortgage obligations issued by SPVs on the MBS model. As many rules in the law apply similarly for both types of securities, for a better understanding they will be presented here together.

For new issues (new series of issues) new cover pools need to be set up. The cover pools itself are dynamic (as defined by the ECB[15]): The cover pool for every issue can be modified in cases, stipulated by the law, to ensure that there is always enough cover for the outstanding mortgage securities.

Credit organisations (Art. 7, sec. 2)

A credit organisation has to comply with the Banking Law and the rules, set up by the Central Bank for credit organisations. If the credit organisation does not fulfil the statutory requirements, the licence can be revoked (Art. 20, sent. 1, no 10 of the Banking Law).

By pt. 1.1 and 2.4 of the Mortgage Cover Mandatory Requirements Instruction, the CBRF has set up a special regulation[16] for the minimal ratio between the volume of the cover pool and the volume of the issued mortgage obligations (N18): 100 % (pt. 1.1, sec. 3 and 2.4 of the Mortgage Cover Mandatory Requirements Instruction).

For credit organisations the excess amount of the cover pool shall not be more than 20% (Art. 13, para. 3, sec. 2).

The Central Bank has not used its right to set a special limit for mortgage obligation issuers for the interest rate and foreign exchange risk[17].

SPVs (mortgage agents, Art. 8)

The mortgage agents are described in detail in the ECBC Fact Book 2011, p. 413 and 2015, p. 393.

Protection of terms

Due to Art. 6, the words "obligation with mortgage cover" (in Russian "obligatsiya s ipotechnym pokrytiem"), mortgage participation certificate ("ipotechnyj sertifikat uchastiya"), mortgage cover ("ipotechnoe pokrytie"), mortgage agent ("ipotechnyj agent") and "mortgage specialized organisation" ("ipotechnaya spezializirovannaya organisatsiya")[18] may be used only for the purposes of the Law on Mortgage Securities.

III. COVER ASSETS

Eligible assets under the Russian Law on Mortgage Securities are mortgage secured claims under a loan or credit agreement, including interest (Art. 3, sec. 1).[19]

Eligible are also money in Russian and foreign currency, state bonds and real estate (Art. 3, sec. 1). Real estate can only be used as cover, if it is purchased in foreclosure of a cover mortgage (Art. 3, sec. 1; Art. 13 sec. 1, para. 3[20]).

Requirements for eligible mortgage secured claims are:

> The mortgage shall content a prohibition on sale of the mortgaged property by the mortgagor without consent of the mortgagee (Art. 3, sec. 2, pt. 2).

> The property has to be insured to the benefit of the mortgagee for the whole term of the loan to an amount not less than the mortgage secured claim (Art 3, sec. 2, pt. 3).

[15] European Central Bank: Mortgage obligations in the EU Financial System, December 2008, p. 7.

[16] On the bases of Art. 7, sec. 2.

[17] But issuing credit organisations have to describe the f/x and the interest rate risk in the prospectus (Annex 2 Part B pt. 2.3.5, StatuteCBRF 454-P).

[18] "Mortgage specialized organization" is another allowed name for "mortgage agent" (Art. 8, sec. 1, para. 5).

[19] Due to the sharp increase of the RUB/USD exchange rate end of 2014 (For 1 USD on 01.10.2014: 39,38 RUB, on 01.01.2015: 56,24 RUB) the Central Bank in its letter dated 23.01.2015 No. 01-41-2/423 proposed to change foreign currency housing mortgage credits to RUB, taking the exchange rate as of 01.10.2014. This will not be seen as a credit restructuring and will not lead to a regulative deterioration of these credits. **NOTE:** This is a possibility, introduced by the Central Bank to enable a currency change, but such conversion is NOT obligatory.

[20] And for not longer than two years since the acquisition (pt. 27.3 Statue CBRF 428-P).

- The share of mortgage secured construction claims is limited to 10% of the cover pool (Art. 3, sec. 3, para. 3). For housing mortgage obligations, mortgage secured construction claims are not eligible (Art. 3, sec. 3, para. 1 sent. 2).
- Claims, secured by a second ranking mortgage are eligible, as far as they do not exceed the LTV limit of 70% (Art. 3, sec. 3, para. 2).
- In the moment of distribution (razmeshcheniye) or delivery (vydacha) of the mortgage obligations the cover cannot sustain of mortgage secured claims, pledged to secure other obligations (Art. 3, sec. 3, para. 1).

One asset may only be used for one cover pool (Art. 3, sec. 5).

IV. VALUATION AND LTV CRITERIA

Due to art. 3, sec. 2, para. 2, the LTV limit is 80% of the market value of the property. If a second ranking mortgage is used for cover, the LTV limit is 70%[21] of the market value (Art. 3, sec. 3, para. 2). In both cases, the valuation has to be made by an independent valuer[22].

The Law does not contain special regulations on valuation for the purpose of mortgage securities.

V. ASSET-LIABILITY MANAGEMENT

Art. 3, sec. 4 stipulates that the amount of the cover is defined by summing up the mortgage secured claims, amount of money in the cover and value of other assets. Details are set up by the FSFR in the Mortgage Cover Determination Order.

The following claims shall not be encountered by summing up the mortgage cover:

- No payment made on the claim for more than six month;
- Loss of the mortgage object, including if the mortgage was declared void by a court;
- Secured obligation declared void by a court;
- Bankruptcy of the debtor; and,
- No insurance of the mortgage object for more than 6 month.
- The cover asset does not fit to the general rules for eligible claims; cover assets can be replaced by other assets (Art. 14, para. 1[23]; Art. 3, sec. 4).

For proper performance of the obligations under the mortgage obligations[24] the amount of the cover pool for the whole maturity of the bonds shall not be lower than the aggregate outstanding nominal value of the bonds (Art. 13, sec. 2, para. 2, sent. 1).[25]

One cover pool can secure two or more tranches of mortgage obligations (Art. 11, sec. 2, para. 1; Art. 13, sec. 2). In this case the rules on calculation of the necessary cover for one tranche apply similarly (Art. 11,

[21] Including the first ranking mortgage.

[22] The valuers' profession and independence of the valuer is regulated in the Valuation law.

[23] The Securitzation law adds the possibility to replace assets, if this is forseen in the decision on the issue and consented by the "bond holders' representative" (in Russian: Predstavitel' vladeltsev obligatsiy). The representative was introduced by the Federal law dated 23 July 2013 No 210-FZ (SZ, 2013, No 30 (part I), item 4043) into Art. 29.1 – 29.11 of the Securities' market law (changes comig into force on 1 July 2014). In principle the appointment of a representative is voluntary, obligatory only under certain defined circumstances. The representative has to secure the interest of the bond holders in front of the issuer, a security provider, as well as state institutions, including courts.

[24] In Russian "nadlezhashchoe ispolnenie obyazatel'stv po obligatsiyam s ipotechnym pokrytiem".

[25] Moody's assigned a timely payment indicator (TPI) of "Very Improbable", as covered bonds under Russian law accelerate, if the issuer becomes insolvent. Due to Moody's the Law on Mortgage Securities offers limited support for timely payment to the covered bond holders, after issuer default. (Moody's Investors Service: Pre-Sale Report: DeltaCredit Bank Mortgage Covered Bonds, 20 November 2012 and 19 July 2013, in both reports p. 2).

sec. 2, para. 1). If mortgage securities are issued in several tranches on the bases of one cover pool, the volume of the cover pool has to be not less than the nominal value of each tranche together with other tranches with similar or foregoing ranks (Art. 13, sec. 2, para. 3). Among the two or more tranches the issuer may define an order of priorities: The performance of claims of one tranche is only allowed after proper performance of the claims of the higher ranking tranche(s) (Art. 11, sec. 2, para. 2[26] and 3). The rule, that for all tranches at any time the cover rules are fulfilled, can be excluded for the junior tranche by the decision on the issue (Art. 11, sec. 2, para. 1; Art. 13, sec. 6).

Money received from the repayment of the mortgage secured claims has to be included into the cover pool as far as this is necessary to fulfil the legal stipulations on the volume of the cover pool (Art. 13, sec. 4). Only at the moment of formation of the cover pool, it has to sustain for 100% of mortgage loans. After issuing the bonds, due to amortisation of the cover pool, this share will reduce. To avoid the consequence of necessary prepayment of the issue, and the risk that potential new cover mortgage loans will not fit to the parameters, the money from regular repayments of the mortgages has to be included into the cover pool.[27]

The mortgage securities' holders have the right to claim for prepayment of the mortgage obligations in the following cases (Art. 16, sec. 1): Breach of the rules regarding:

> Volume of the cover pool;

> Replacement of cover assets;

> Proper fulfilment of obligations under the mortgage obligations;

> The issuer is active in fields not allowed for it; and,

> Other reasons stipulated by the decision on issuing mortgage obligations.

A time frame to claim for prepayment has to be set up in the decision of the issue and shall not be less than 30 days from discovery or disclosure by the issuer of the prepayment right to the mortgage securities' holders (Art. 16, sec. 3, sent. 1). After this term the right to claim for prepayment ends (Art. 16, sec. 1, sent. 2). If the prepayment right arose in connection with a breach of the rules for the volume of the cover pool and/or the proper fulfilment of obligations under the mortgage securities as described in Art. 13, the right to claim a prepayment ends on the date of discovery or disclosure of information by the issuer of elimination of the breaches (Art. 16, sec. 3, sent. 2).

The issuer has to inform the mortgage securities' holders, that the right to claim for prepayment has arisen, the value of the securities, the procedure of prepayment and the termination of this right (Art. 16, sec. 2).

VI. TRANSPARENCY

The Law on Mortgage Securities stipulates a wide range of publishing information on the mortgage obligations by the issuer (Art. 37 – 41). In addition to the main rules according to the Securities Market Law (Art. 37, para. 1; Art. 40, sec. 1), important information is an account report on performance of the cover assets (Art. 40, sec. 4, para. 2). Credit organisations issuing mortgage obligations have special reporting duties to the Central Bank (Art. 7, sec. 1, para. 3; pt. 3.1 – 3.5 of the Mortgage Cover Mandatory Requirements Instruction).

Main points for publishing information are:

> If the mortgage obligations are rated by a rating agency, this rating has to be published (Art. 37, para. 2).

> Interested persons have the right to get knowledge of the cover register (Art. 39, para. 1)[28].

[26] The Securitization Law clearifies this rule regarding interest.

[27] See pt. 5 Explanatory Memorandum of the authors of the draft dated 19 August 2011.

[28] The cover register contains information on the mortgage claims on the loan-level basis (Art. 5).

> The regulator set up further special rules for mortgage obligation issuers in the general regulations on disclosure of information[29].

VII. COVER POOL MONITOR, COVER REGISTER AND BANKING SUPERVISION

Cover pool monitor

The cover pool is controlled by a cover monitor (the "specialized depositor of the mortgage cover"[30]), Art. 33, sec. 1. The cover monitor has to be a commercial organisation[31], licensed for (i) activity as special depositor for investment funds, share investment funds and non-state pension funds as well as for (ii) performance of depositary activities on the securities' market (Art. 32, para. 2). The FSFR has published the Special Depositor Decree.

The duties and tasks of the cover pool monitor are described in the ECBC Fact Book 2012, pp. 418 – 419.

Cover register

Cover assets have to be registered in a "register of mortgage cover"[32] (Art. 5). The FSFR has adopted Register Maintenance Rules[33].

Details are described in the ECBC Fact Book 2012, pp. 419 – 420.

Supervision

Since 2013 the financial sector and banking system is supervised by the Central Bank of the Russian Federation as so-called "mega regulator".

Concerning mortgage securities the state regulation of issuing mortgage securities (Art. 42 – 46) as well as the supervision of banks, issuing mortgage securities, is done by the Central Bank (Art. 7, sec. 2).

Issuing of mortgage obligations

For details of this process see ECBC Fact Book 2012, pp. 420 – 421.

For issuing securities, Russian law foresees a five step process[34]: (i) Taking the decision on issue, (ii) approval of the decision, (iii) state registration of issue or assignment of identification number to the issue, (iv) placement of securities and (v) state registration of the report or notification on results of the issue. For these general steps, the CBRF set up special requirements for the issue of mortgage securities.

VIII. SEGREGATION OF COVER ASSETS AND BANKRUPTCY REMOTENESS OF MORTGAGE OBLIGATIONS

The claims of the mortgage securities' holders are secured by a pledge over the cover pool (Art. 11, sec. 1).

Asset segregation

In case of bankruptcy the cover pool is excluded from the bankruptcy estate of the issuer (Art. 16.1, para. 1 of the Law on Mortgage Securities; Art. 131, sec. 2, para. 3; Art 189.91, sec. 2 para 1 and 4 of the Bankruptcy Law).

The insolvency administrator is obliged to open two special bank accounts for the cover pool to collect the money paid on the mortgage secured claims or from realization of these claims and to make payments to the mortgage obligations' holders (Art. 133, sec. 4 of the Bankruptcy Law). A special administrator of the cover pool, different from the insolvency administrator of the general bankruptcy estate is not foreseen.

[29] Statute CBRF No. 454-P. Special rules for mortgage securities are foreseen in Section VIII, chapter 76 – 78, Annex 1 pt. 4.2, Annex 2 Part B pt. 8.12.3 and 9.4.1, Annex 3 Part B pt. 8.4.1.

[30] In Russian "spetsializirovannyj depozitariy ipotechnogo pokrytiya".

[31] Not affiliated with the issuer (Art. 33, sec. 3, para. 2).

[32] In Russian "reestr ipotechnogo pokrytiya".

[33] The "register" contains information on loan-level basis (Art. 5).

[34] Pt 1.1 Statute CBRF No 428-P, special rules for mortgage securieites are foreseen in section VII, chapter 27 – 30 and Annex 16 of this Statute.

Impact of insolvency proceedings on mortgage obligations

The Law on Mortgage Securities stipulates two possibilities of realization of the cover pool in case of bankruptcy of the issuer (Art 16.1, para. 2):

> Change of the issuer ("zamena ėmitenta obligaciy s ipotechnym pokrytiem"): The cover pool will be sold with the obligation for the buyer to fulfil all conditions of the decision on issuing the mortgage obligations. Details have to be stipulated by a federal law. This federal law has not been enacted yet.

> Selling of the cover pool ("prodazha ipotechnogo pokrytiya"): The cover pool assets will be sold and the money received will be distributed among the mortgage obligations' holders. The mortgage obligations accelerate.[35]

Preferential treatment of mortgage obligations' holders

Mortgage obligations' holders enjoy preferential treatment as the Russian law stipulates the separation of the cover pool from the general insolvency estate of the issuer (Art. 16.1, para. 1).

In case they are not satisfied in the realization of the cover pool, the mortgage obligations' holders may ask for satisfaction from the general bankruptcy estate of the issuer (Art. 16.1, sec. 1 para. 3).

They are also enjoying a preferential treatment against deposit holders, as the cover pool – securing mortgage obligations – is excluded from the general bankruptcy estate, which in turn secures depositors on preferential bases[36].

For details to access to liquidity in case of insolvency and sale and transfer of mortgage assets to other issuers, see ECBC Fact Book 2012, p. 423.

Enforcement into the cover pool

Russian Covered Bond Law allows for enforcement of the covered bond holders into the cover pool (Art. 15). The general realization rules of the Mortgage Law will apply. In case of different issues with different ranking, the ranking has to be kept in distribution of the receipts (Art. 15, sec. 3).

If an issue sustains of several tranches, the foreclosure in one tranche is only allowed upon an application of the bond holders' representative (Art. 15, sec. 1, para. 3).

IX. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION; ECBC LABEL CONVENTION

Russian mortgage obligations (mortgage obligations, issued by credit organisations) comply with the requirements of Art. 52, sec. 4 UCITS and the ECBC Label Convention (see ECBC Fact Book 2012, pp. 424 – 426). The CRR is fulfilled for mortgage obligations, issued by banks, where the cover pool sustains only of housing mortgage loans (e.g. housing mortgage obligations). For mortgage obligations, secured by commercial mortgage loans, the CRR requirements (Art. 129, sec. 1, lit. f) are not fulfilled, as a loan to value up to 80% of the market value is allowed under Russian law as cover asset (see ECBC Fact Book 2014, pp. 328 – 403).

Mortgage obligations still enjoy a privileged risk weighting compared to other non-public securities: Mortgage obligations are weighted with 100% instead of 150%[37].

[35] Due to art. 16.2, sec. 3, para. 3 and 4 in case if one (or severeal) bond holders' representatives are appointed for the covered bonds secured by one cover pool (for several tranches secured by one cover pool) the bankrupcy receiver will transfer the money to special account of the representative. The representative will distribute the mony among the the bond holders.

[36] See the Explanatory Memorandum of the authors dated 01 February 2011, the Official Opinion of the Government of the Russian Federation dated 6 July 2011 and the Conclusions of the Financial Markets' Committee of the State Duma as of 20 September 2011 and 24 January 2012 to draft law no 495103-5 (enacted as Federal law dated 25 June 2012 No 83-FZ).

[37] See also ECBC Fact Book 2012, p. 426. This privilege is also based on pt. 2.3.4., Schedule 1 Designation code "8815" of the new Instruction CBRF No 139-I/2012.

X. ADDITIONAL INFORMATION

Investment regulations

The EU investment regulations for mortgage obligations are not transferred into Russian law. Nevertheless, different investment rules and privileges for mortgage securities do exist. E. G. earlier this year the Central Bank has set up new rules for investing pension deposits of non-state pension funds in different asset classes.[38] Along with fulfilling the rules of the Mortgage Securities Law, the Statute stipulates additional requirements to covered bonds and the issuing credit organisations.[39]

> Figure 1: Overview over the issues of bank mortgage obligations (covered bonds)[40]

	Date	Issuer	Tranches	Volume		Interest	Maturity
				mRUB	mEUR[41]		
1	11.10.2007	Moscow Mortgage Agency		2,000.0	56.7	12.5%	01.10.2015
2	14.09.2011	Unicreditbank		5,000.0	121.3	8.20%	07.09.2016
3	21.09.2011	VTB 24		5,000.0	116.5		26.11.2043
			A	3,333.3	77.7	9.00%	
			B	1,666.7	38.8	3.00%	
4	09.11.2011	DeltaCredit		5,000.0	119.2	8.33%	02.11.2016
5	14.09.2012	VTB 24		6,000.0	147.9		
			A	4,000.0	98.6	9.00%	15.09.2044
			B	2,000.0	49.3	3.00%	15.09.2044
6	11.12.2012	DeltaCredit		5,000.0	125.5	9.15%	05.12.2017
7	02.04.2013	DeltaCredit		5,000.0	125.6	8.50%	02.04.2016
8	23.05.2013	VTB 24		6,000.0	148.8		01.09.2044
			A	4,000.0	99.2	9%	
			B	2,000.0	49.6	3%	
9	10.07.2013	Delta Credit		5,000.0	117.3	8.65%	04.07.2018
10	05.09.2013	DeltaCredit		5,000.0	113.5	8.45%	30.08.2018
11	18.12.2013	VTB 24		12,300.0	271.7		18.09.2046
			A	8,200.0	181.2	9%	
			B	4,100.0	90.6	3%	
12	27.03.2014	DeltaCredit		5,000.0	102.1	12%	27.03.2024
13	10.12.2014	Gazprombank		7,000.0	104.7		27.04.2048
			A	4,666.7	69.8	9%	
			B	2,333.3	34.9	3%	
Total				**73,300.0**	**1,670.7**		
Redeemed Issues	16.12.2009	VTB 24		15,000.0	341.3	9,70%	
	Redeemed	10.12.2014					

ECBC Covered Bond Comparative Database: http://www.ecbc.eu/framework/41/Mortgage_Obligations_.

[38] Statute approved by the Central Bank on 25.12.2014 No. 451-P (registered by the Ministry of Justice, 23.01.2015, No. 35661; published: Herald (Vestnik) of the Central Bank, No. 6 (1602), 29.01.2015, p. 44 – 50, here following: Statute CBRF No. 451-P), accompanied by a decision of the Council of the Central Bank dated 19.02.2015 (published: Herald (Vestnik) of the Central Bank, No. 16 (1612), 26.02.2105, p. 6 – 8). This decision is based on pt. 1.4.7. of Statute CBRF No. 451-P.

[39] Pt. 1.4.1. sec 1, 1.4.3, 1.4.4., 1.5.6. of Statute CBRF No. 451-P.

[40] Details of the issues can be found on www.cbonds.info.

[41] CBRF exchange rate as of date of issue.

3.28 SINGAPORE

By Colin YS Chen, DBS Bank, and Franz Rudolf, UniCredit Bank

I. FRAMEWORK

On 31 December 2013, the Monetary Authority of Singapore (MAS) published its regulations regarding the issuance of covered bonds by banks incorporated in Singapore (MAS Notice 648). The regulations became effective 31 December 2013, and the requirements set out in the notice are mandatory for Singapore's banks as MAS Notice 648 is part of The Banking Act in Singapore. The regulation outlines MAS' rules relating to the issuance of covered bonds by banks incorporated in Singapore and will enable Singapore's banks to gain access to longer term, stable funding options as well as to facilitate the diversification of funding sources for the banking and financial markets in Singapore. DBS Bank Ltd was the first to have established its covered bond programme under the new regulations on 16 June 2015 and on 30 July 2015, issued the inaugural Singapore covered bond, pricing USD1 Billion, fixed rate covered bonds due 2018 under its USD10 Billion Covered Bond Programme.

In January 2015, MAS proposed an amendment to its regulation regarding the issuance of covered bonds. Comments were collected until the end of February 2015 and the amendments were published on 4 June 2015.

Singapore's covered bonds will be based on contractual agreements and will be governed by the law of contracts under common law, which applies to all elements of the covered bond structure. This – together with the implemented specific covered bond regulations – creates a framework comparable with that of other European jurisdictions, e.g. in the UK, via a more prescriptive regulatory framework.

Singapore's legal system is similar to the legal system in the UK in that the covered bond structure is fundamentally based on statutes or acts, which have been formally enacted by the legislative authority of the Republic of Singapore. It is considered a primary authority and source of law and determines the applicable legislation. The MAS guidelines arising from the MAS Notice 648 and its amendment provide clarity on the characteristics of a Singapore covered bond.

Singapore covered bonds will be a direct and unconditional obligation of the issuer, and in the event of a default or insolvency of the issuer, investors in the covered bond will have dual recourse: first, an exclusive senior secured claim on the pool of cover assets and second, a senior unsecured claim on the issuer. The cover pool assets will be held in a special purpose entity, which, in turn, will provide a guarantee in respect of the principal and interest payments under the covered bonds' outstanding. A bond/security trustee is appointed to hold the security over the cover pool for the benefit of the covered bond investors.

II. STRUCTURE OF THE ISSUER

In the MAS Notice 648 covered bonds are defined as "bonds, notes or other debentures issued by a bank or an SPV (Special Purpose Vehicle) where the payments of the liabilities to the holders of such covered bonds and any liabilities arising from the enforcement of the rights of the holders of the covered bonds are: (a) secured by a cover pool; and (b) recoverable from the bank whether or not the cover pool is sufficient to pay off such liabilities." This implies the dual recourse nature of covered bonds with a claim of covered bond holders against the cover pool as well as the issuing bank. The cover pool, in this context, comprises the eligible assets owned by the bank or an SPV for the purpose of securing the liabilities to the holders of the covered bonds only. MAS Notice 648 is applicable to all banks incorporated in Singapore. In order to issue covered bonds, the bank has to notify MAS at least one month prior to the issuance of covered bonds. In addition, issuers will have to submit to the MAS a Memorandum of Compliance, confirming that the guidelines with respect to the program and issuances for covered bonds have been adhered to and complied with.

III. COVER ASSETS

The cover pool may consist of the following assets, according to §6 of Notice 648:

> Mortgage loans secured by residential property ("residential mortgage loans"), whether in Singapore or elsewhere (no geographic limitation to mortgage loans); the loan-to-value (LTV) limit is set at 80% ("soft limit"), taking into account the current market value of the residential property;

> Any other loans secured by the same residential property as the residential mortgage loans;

> Assets, including intangible properties, that form part of all the security provided for the residential mortgage loans, such as guarantees and indemnities;

> Derivatives held for the purpose of hedging risks arising from the particular issuance of covered bonds;

> Cash (including foreign currency);

> Singapore Government Securities, and

> MAS Bills.

The aggregate value of substitute collateral (cash, treasuries and MAS Bills) is limited to 15% of the cover pool. The 15%-limit can be temporarily exceeded in order to allow the issuer to build up the necessary liquidity to meet payments in the upcoming 12 months or to account for operational timing differences.

MAS imposed to limit the amount of collateral in the cover pool at 4% of total assets of an issuer. Total assets of the bank includes assets of the branches but does not include assets of the subsidiaries of the bank. For the purpose of determining the total assets of a bank, the bank shall exclude assets it uses to meet regulatory requirements under sections 38, 39 and 40 of the Banking Act, section 8 of the Deposit Insurance and Policy Owners' Protection Schemes Act and other regulatory requirements as may be prescribed or specified by MAS. Commercial mortgage loans or public sector loans are not eligible.

IV. VALUATION AND LTV CRITERIA

The legal framework sets an 80% loan-to-value (LTV) limit for the eligibility of residential mortgage loans. The LTV limit is a soft limit, meaning that in case a mortgage loan exceeds 80%, the loan can still be included in the cover pool, but only the value up to 80% is given credit to when determining the value of the cover pool. The value of the underlying collateral is determined by the current market valuation of the residential property that is used to secure the residential mortgage loan. A valuation of residential properties used to secure the loans shall be conducted on an annual basis.

V. ASSET – LIABILITY MANAGEMENT

MAS Notice 648 §6(h) stipulates a mandatory minimum overcollateralisation (OC) of 3% on a nominal basis as "... the value of assets in a cover pool shall be at least 103% of the outstanding nominal amount of the covered bonds secured by the assets at all times." Covered Bond issuers shall in accordance with MAS Notice 648 §8(a) perform regular asset coverage tests (ACTs) to ensure collateral quality and the proper level of overcollateralisation. In addition, regular stress tests on risks related to default, prepayment, currency, interest rate, counterparty and liquidity have to be performed. Details regarding these tests will be addressed in the respective covered bond programs of Singapore issuers.

VI. TRANSPARENCY

Covered bond issuers shall disclose to the covered bond holders the results of asset coverage tests (ACTs) performed and cover pool characteristics on a regular basis and in any event, at least every quarter, according to MAS Notice 648 §8(e).

VII. COVER POOL MONITOR AND BANKING SUPERVISION

According to §8(b), a cover pool monitor shall be appointed. The cover pool monitor, who has to be an external third party qualified to be an auditor under the Companies Act (Cap 50), has to verify the compliance of the covered bond issuer with Notice 648 regulations and report these to MAS. A certified report has to be submitted to the Authority annually in the first quarter following the end of the bank's financial year. The duties of the cover pool monitor explicitly include to:

> verify annually that the bank complies with covered bond-specific regulations (asset cap, eligible assets, LTV limits, overcollateralisation, et al as defined in §6(a) to (h));

> verify annually that the bank keeps an accurate register of the assets in the cover pool;

> assess the adequacy of the bank's risk management process and internal controls relating to the covered bond program annually;

> submit a certified report to MAS annually on compliance with covered bond regulations; and

> report to MAS immediately if it becomes aware that the bank has breached any of the conditions imposed.

Singapore's covered bond regulations stipulate that the issuing bank shall ensure adequate risk management processes and that internal controls are in place to manage the risks arising from the issuance of covered bonds, including appropriate governance arrangements and regular stress tests on risks arising from issuing covered bonds such as default, pre-payment, currency, interest rate, counterparty and liquidity risks. This also includes having governance processes in place with respect to the authority to approve any issuance of the covered bond. Finally, regulations state that the board and senior management of the issuer are responsible for conducting due diligence in assessing the risks associated with issuing covered bonds and ensuring that risk management processes that are put in place for covered bonds are adhered to.

VIII. SEGREGATION OF COVER ASSETS AND BANKRUPTCY REMOTENESS OF COVERED BONDS

Given that Singapore's legal system is based on Commonwealth common law, a similar structure applies as used for the issuance of covered bonds in the UK, Canada, Australia, or New Zealand. Thus, covered bonds will be issued by a bank, with the cover pool collateral sold by way of an equitable assignment or by declaring a trust over the collateral to a Special Purpose Vehicle (SPV). The covered bond will benefit from dual recourse on the issuer and the cover pool. This structure ensures the segregation of the cover assets from the insolvency estate of the issuer in the case of an issuer default. The contractual agreements for the issuance of covered bonds are structured within the general legislation in Singapore.

IX. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

Singapore covered bonds are neither Article 52(4) UCITS nor Article 129 CRR compliant given that Singapore is not a member state of the European Union. As such, it is unlikely that Singapore covered bonds will benefit from preferential risk-weighting for regulatory capital purposes. However, regulations constitute a covered bond framework that broadly complies with European standards. Once issuance of covered bonds has started in Singapore, covered bonds are expected to be LCR eligible in Singapore.

X. ADDITIONAL INFORMATION

The mortgage loan-to-GDP[1] ratio in Singapore was 46.36% in 2014, up from 44.85% in 2013. Home ownership is relatively high and is dominated by the public home ownership sector (Housing & Development Board ("HDB")). According to data from Yearbook of Statistics 2014, approximately 90.5% of the total housing stock are owner-occupied in 2013, with 75.8% being public housing and the remainder, private housing. Landed properties comprise approximately 5.53% of the total housing stock in 2013. Based on the household sector balance sheet, total housing loans in 4Q2014 (SGD 216.71 bn) rose 5.53% from 4Q2013 (SGD 205.35 bn). According to data from MAS, outstanding limits granted for owner-occupied housing loans amounted to SGD 150.43 bn in 4Q2014, up from SGD 142.48 bn in 4Q2013. The average loan-to-value ratio was 49.2% and the total non-performing loan ratio was 0.4% in 4Q2014.

Issuers: DBS Bank Ltd.

ECBC Covered Bonds Comparative Database: http://www.ecbc.eu/framework/111/Singapore_Covered_Bonds.

Covered Bond Label: DBS Bank Limited USD10 billion Global Covered Bond Programme.

[1] Mortgage loan is taken as the total outstanding housing loans (both owner-occupied properties and investment properties) that are utilised as reported by MAS. GDP is quoted at current market prices as reported by Department of Statistics Singapore ("http://www.singstat.gov.sg").

3.29 SLOVAKIA

By Eva Horvátová, University of Economics in Bratislava

I. FRAMEWORK

The issue of mortgage bonds is regulated by Act No. 530/1990 Coll. Act on Bonds, Part Four – Special types of bonds, Section 1 – Mortgage bonds, Articles 14 – 17. According to Article 14 of the Act on Bonds, a mortgage bond shall be a bond whose par value, including yields therefrom, is duly covered (Article 16.4) by the receivables of a bank or branch of a foreign bank from mortgage loans backed by rights of lien on real estate properties or by substitute coverage (Article 16.5) and shall have the designation "mortgage bond" („hypotekárny záložný list") in its title. Mortgage bonds may be issued only by mortgage bond issuing institution, meaning by banks with the license to perform mortgage deals. The minimum amount of bank equity capital, which is needed for obtaining the mortgage bank license, equals EUR 33 Mio, whereas previously it was SKK 1.000.000.000.

Banks shall use the proceeds from the sale of mortgage bonds only to perform mortgage deals under a separate regulation.

There are two types of coverage: ordinary coverage and substitute coverage. For an ordinary covering of mortgage bonds, receivables of mortgage banks from mortgage credits are used, not exceeding 70 % of the value of the mortgaged real estate set under a separate regulation.

Article 16 of the Act on Bonds defines the basic characteristics of Slovak mortgage bonds, duly (ordinary) and substitute covering of mortgage bonds.

Specific requirements of legislation are aimed at the quality of mortgage bonds in relation to investors and in relation to the stability of mortgage banks.

The separate regulation aimed at the quality of mortgage bonds in relation to investors – buyers of mortgage bonds covers:

> The rules of keeping a mortgage register;

> The status and role of the trustee (mortgage controller) and his deputy;

> The real estate valuation methods; and

> The obligation to keep a separate analytical record of mortgage deals within the bank's accounting system.

Preferential right of creditors – owners of mortgage bonds, requires that the mortgage credits and other values of substitute coverage have to be distinguishable from the insolvency estate of the bank because the mortgage loans have to serve as due (ordinary) coverage for mortgage covered bonds, just as many other items serving as substitute collateral. These values (mortgage loans and substitute collateral) have to be recorded in separate mortgage (coverage) register in the issuing bank and its adequacy has to be controlled by mortgage trustee.

With respect to the general approach to covered bonds, the model applied by Slovak lawmakers is similar to the common practice in Germany.

In the early stages of development of mortgage banking in Slovakia, it was problematic to issue mortgage bonds due to the fact the yields on the capital market were very high. This would mean that the mortgage banks should have an expensive resource.

In order to overcome the problems of firstly-issued mortgage bonds, there is the possibility to issue temporary mortgage bonds.

The temporary mortgage bonds are regulated by Article 17 of the Act 483/2001 on Banking Coll.

Within eighteen months of the effective date of the mortgage license a bank, on the basis of a decision of its General Assembly, may issue temporary mortgage bonds in the form of bearer securities. The total nominal par value of these temporary mortgage bonds shall not exceed 50% of the bank's capital. Within two years of the issuance of temporary mortgage bonds, the bank shall replace them for mortgage bonds covered under Article 16. In the time between issuing temporary mortgage bonds until their exchange for mortgage bonds covered under Article 16, the provisions of a separate law shall not be applied. A temporary mortgage bond shall be connected with rights resulting from the mortgage bonds that the temporary mortgage bond replaces. If a bank does not exchange temporary mortgage bonds for mortgage bonds covered under Article 16 within two years of issuing of the temporary mortgage bonds, it shall be bound to repay the temporary mortgage bonds at their par value, including yields on them for the period from their issue to the repayment.

A temporary mortgage bond shall lapse through its exchange for a mortgage bond covered under Article 16 or through their repayment.

It is interesting to note that in the practise of Slovak mortgage banking, the conception of temporary mortgage bonds has not been realised up to now. A temporary mortgage bond remains only as a potential opportunity to obtain resources for any new mortgage banks in Slovakia, because the possibility of emissions is only two years after the establishment of the new mortgage bank.

Few mortgage bonds in Slovakia are traded on the secondary market. Issuers of mortgage bonds in the country are providing universal banking services and operations too. Therefore, it is necessary to work on increasing the confidence of investors in mortgage bonds and increasing of the liquidity of mortgage bonds at national level. The adoption of the euro created the conditions for investment by foreign investors in mortgage bonds.

II. STRUCTURE OF THE ISSUER

The mortgage bonds issuers in Slovakia are universal credit institutions with the license to conduct mortgage business.

In accordance with the Act on Banks, No. 483/2001 and with Regulation of NBS 12/2001 establishing, the elements of the application for a banking license as minimum requirements to obtain and keeping the special mortgage licence are as follows:

> Minimum amount of the bank equity capital is SKK 1,000,000,000 (EUR 33,193,919) or an equivalent amount in fully convertible foreign currency;
> Development strategy of mortgage loans in the first three years;
> Business plan for mortgage lending in the first three years divided in accordance with the balance sheet structure and the structure of the income statement;
> Information on organisational and personnel issues of providing mortgage loans;
> General conditions of mortgage and municipal loans;
> Information on keeping of the register of mortgages in accordance with the specific regulations of the register;
> Method of separate analytical accounting system;
> Documents with regard to the fulfilment of requirements on persons nominated for supervisor (trustee) and his/her deputy;
> Real estate assessment methods (valuation);
> Proposed amount of remuneration for a supervisor (trustee) and his/her deputy;
> Statement of the supervisor (trustee) that the provided documents are current, accurate and complete.

Basic requirements, principles, rules, limits of mortgage credits are included in Part Twelve – Mortgage Banking, Articles 67 – 88.

The issuer of mortgage bonds also owns the cover assets and holds them in his balance sheet. The holder of the bond has a direct recourse to the credit institution. The issuer has a position of permanent issuer, which means that he may issue bonds according to his economic needs and does not need a permit by a supervisory authority.

There is no direct legal link between single parts of the cover assets and the Hypotekárny záložný list (HZL); all liabilities of the issuer relating to mortgage bonds (HZL) are obligations of the issuing bank as a whole, to be paid from all the cover assets that the issuer holds.

III. COVER ASSETS

Standard conditions of ordinary and substitute covering of mortgage bonds are applicable in Slovakia. The ordinary covering is guaranteed by bank receivables from mortgage credits and provided to 70 % of the real estate's value.

In according with Article 72 of the Act on Banks 483/2001, the issued mortgage bonds and municipal bonds may be duly secured only by a mortgage bank's claim from mortgage and municipal loans. These loans are secured by a lien on real property and do not exceed 70% of the value of pledged real property. Mortgage and municipal loans going beyond the limit 70% of the value of pledged real property may only be granted on the condition that the total amount of claims of a mortgage bank overrunning the limit does not exceed 10% of the total amount of outstanding mortgage and municipal loans.

Assets used to cover the nominal value of issued mortgage bonds and municipal bonds, including liens on real property, may be neither pledged by the mortgage bank nor otherwise used to guarantee its other liabilities.

Mortgage bond owners shall have preferential right to assets used to secure issued mortgage bonds, including lies on the real property. Municipal bond owners shall have preferential right to assets used to secure issued municipal bonds, including lies on real property. The mortgage bank has a pledge right.

The substitute covering is possible up to 10 % from the value of issued mortgage bonds. The following property values belonging to the mortgage bank may be used for the purposes of substitute coverage:

- Deposits in the National Bank of Slovakia (NBS);
- NBS bills (currently not issued);
- Deposits in banks with registered offices in Slovakia;
- Deposits in branches of foreign banks in Slovakia;
- Cash;
- Treasury bonds;
- Treasury bills; and
- Covered bonds issued by another bank.

The definition of mortgage and municipal loans can be found in Article 68 of the Slovak Banking Act Nr 483/2001 Coll. According to this Article, a mortgage loan is a loan with a maturity of at least four years and a maximum maturity of thirty years, secured by a lien established upon a domestic real estate. The domestic real estate could be under construction and financed up to at least 90 % through the issuance and sale of mortgage bonds by a mortgage bank under a separate regulation.

Mortgage banks provide mortgage loans for the following five purposes:

1) Acquisition of domestic real property or any part thereof;
2) Construction or modification of existing buildings or structures;
3) Maintenance of domestic real properties; or

4) Repayment of an outstanding mortgage loan drawn for any of the purposes mentioned in subparagraphs 1) to 3);

5) Repayment of an outstanding loan drawn for any of the purposes mentioned in subparagraphs 1) to 3), other than a mortgage loan.

A municipal loan is defined as a loan with a maturity of at least four years and a maximum of thirty years. It is secured by a lien on real property, owned by a municipality or a higher territorial unit, and in the same time financed up to at least 90% through the issuance and sale of municipal bonds under a separate regulation. Banks provide municipal loans for the purposes acquisition of domestic real property, construction or modification of existing buildings, for maintenance of domestic real properties, with the objective of using them for public.

The Act on Banking requests otherwise, that mortgage loans have to be financed by the issue and sale of mortgage bonds by a mortgage bank in amount at least 90 %. The National Bank of Slovakia may, in its decision issued on the basis of a mortgage bank's application, for reasons worthy of special attention, for a period of maximum two years, stipulate special conditions for financing mortgage and municipal loans up to at least 70%. Banks can do so through the issuance or sale of mortgage bonds by a mortgage bank under a separate regulation 61 or through the issuance and sale of municipal bonds by a bank under a separate regulation, even repeatedly. A reason worthy of special attention is, in particular, an attempt to maintain the stability of the financial sector.

In order to be eligible, a bank may grant loans also above this limit; however, the total amount of loans with LTV ratios larger than 70% are capped at 10% of the total amount of mortgage loans granted by the bank. These mortgage loans do not serve as mortgage bonds coverage, and therefore, the part above 70 % cannot be included in the relevant cover pool. A mortgage loan may not be secured by a lien on the real estate, on which a lien has already been established and continues in favour of a third party. As already indicated, substitute collateral may be used up to a share of 10% of the total nominal value of issued covered bonds.

It is important to note that neither the secondary market of mortgages nor that of derivatives are usable in Slovak mortgage banking.

IV. VALUATION AND LTV CRITERIA

Valuation and LTV criteria are included in Articles 73 – 74 of the Act 483/2001 on Banking Coll. For the purposes of mortgage banking, the value of real estate property shall be determined on the basis of an overall assessment of the real estate. The mortgage bank may only take into account the permanent features of the real estate property and the benefits that can be derived for the owner from the real estate in its normal use in the long run. For real estate burdened by a lien on the same real estate, a mortgage bank shall lower the value of this real estate by the amount of claims guaranteed by such real estate.

A mortgage bank shall only be bound by its own valuation of real estate, in accordance with Article 73(2).

A lien as a guarantee for mortgage bank's claims from mortgage loans or municipal loans shall be established through its entry into the real estate register under a separate regulation, on the basis of a proposal of the mortgage bank and on the basis of the owner of the real estate. The mortgage bank shall have the status of a mortgagee.

A mortgage loan or a municipal loan may not be secured with a lien on the real property in which another lien has already been established and is still outstanding. This holds true except for a lien established in favour of the same mortgage bank in order to secure another mortgage loan or a lien established in favour of a home savings bank, or the State Housing Development Fund.

The lien ceases to exist with the repayment of the debt for which the lien was used for hedging purposes. A mortgage bank shall notify the extinction of the lien on real estate to the Land Register.

The lien of mortgage banks must be mentioned at the first position for purposes of order, thus satisfying the mortgage banks, which are also the creditors.

In enforcing its lien, a mortgage bank may sell the real property on the basis of an agreement made in the form of a notarial deed between the mortgage bank, its borrower, and the mortgagor. Such agreement shall establish a legal obligation, and specify the beneficiary and the person subject to this obligation, the legal grounds, objects, and the time limit for its fulfilment.

Monitoring requirements result from the Decree of the National Bank of Slovakia of 13 March 2007 on banks' own funds of financing and banks' capital requirements and on securities dealers' own funds of financing and securities dealers' capital requirements, Article 110, subparagraphs a) – d).[1]

The LTV ratio limit for commercial and residential property is established at 70% of the mortgage lending value of the property. The LTV is calculated from the mortgage lending value. Mortgage lending value is set at the property value or less than the market value of the property. This LTV is a relative limit, i.e. when the loan exceeds the 70% limit; the part of the loan up to 70% LTV is not eligible for the cover pool. Over this limit a bank may grant mortgage loans exclusively if their total value does not exceed 10% of the total amount of mortgage loans granted by the bank. The bondholders do not get benefit from the loans, which exceed the LTV cap.

V. ASSET-LIABILITY MANAGEMENT

Article 16(4) of the Act on Bonds requires that the total HZL outstanding amount must be covered at all times by assets of at least the same amount and with at least the same interest income. Thus, the nominal value of the cover assets must permanently be higher than the respective total value of the HZL and the interest yield must be at least the same.

Mortgage banks in Slovakia are universal banks with the license for mortgage business. They do not pursue separate margins on mortgage business, because interest on mortgage loans is based on income from annuities and mortgage bonds are established based on direct interest. Therefore, interest income cannot be compared on the basis of a simple difference in interest rates on mortgage bonds and loans. Expenses and income from mortgage transactions are shown only as a total balance sheet of commercial banks without special evidence of mortgage business.

Prepayment of mortgage loans is solved in a standard way, It does not increase the risk of banks and the risk of the mortgage bonds' owners. Banks allow the prepayment in part or in full only when the interest rate of mortgage loans changes.

Cash flow mismatch between cover assets and cover bonds is furthermore reduced by the prepayment rules applicable to fixed interest rate mortgage loans. Prepayments of mortgages are only permitted in cases of "legitimate interest" of the borrower or after a period of the fixation term (this is a part of the loan agreement). In other cases, if the mortgage is prepaid, the borrower has to compensate the damage of the lender caused by the prepayment.

The primary method for the mitigation of market risk uses natural matching and stress testing on the entire bank portfolio, not only the mortgage portfolio. Stress testing of coverage calculations is not applied separately.

There is no mandatory overcollateralisation by the regulation. In practice there is usually coverage of the pools kept on the required levels and over with 1 – 2 %. Minimum mandatory overcollateralisation is not required, but the amounts are protected.

Banks must submit to the supervisory authority information about the residual maturity of financial instruments, including mortgage instruments.

[1] Múčková, V., Sobolič, J.: Slovakia. In: ECBC Covered Bond Fact Book. Brussels: Europe Mortgage Federation, 2014, p. 411 – 412.

VI. TRANSPARENCY

The Slovak mortgage banking system was constructed on the basis of principles of the German mortgage banking system, taking into account the limits of financial markets and some of the specificities of the Slovak economy.

Improvement of the mortgage banking system can lead to improvement in the status of the mortgage bonds and to improve liquidity, stability and efficiency of the mortgage bank.

Initial problems in the financial market, especially high interest rates in the 90s caused problems in issuing mortgage bonds. Later, when interest rates on the banking market reached a standard level, these problems were overcome.

For the purpose of issuing covered bonds, special additional requirements are applicable in comparison to general supervision regulation.

VII. COVER POOL MONITOR AND BANKING SUPERVISION

The cover pool monitor is legally independent from the issuer. Mortgage trustee duties are regulated by the Decree of the National Bank of Slovakia and the Ministry of Finance 661/2004 Coll. on mortgage register and mortgage trustee position.

The prudential supervision of mortgage transactions is performed by the National Bank of Slovakia. The NBS performs authorisation and licensing activities, as well as supervision of liquidity and stability of mortgage banks.

The mortgage trustee:

> Shall supervise the issuance of mortgage bonds and municipal bonds with regard to their particulars and coverage pursuant to separate regulation;

> Shall check that the criteria of coverage are fulfilled and documented;

> Prior to each issue of mortgage bonds or municipal bonds, a trustee shall check the quality of cover assets;

> A mortgage trustee shall check whether a mortgage bank provides mortgage and municipal loans, including their securing through mortgage, and whether a mortgage bank meets its obligations in regard to the mortgage register in accordance with the Banking Act, Act on Bonds and other generally binding regulations;

> Evaluate the exposure to market, operational and liquidity risk;

> If requested by a mortgage bank, to assist in activities related to the performance of mortgage operations.

VIII. SEGREGATION OF COVER ASSETS AND BANKRUPTCY REMOTENESS OF COVERED BONDS

The cover register records the cover assets relating to issued mortgage bonds. The list of mortgage loans and municipal loans, their amounts, liens, mortgage bank's claims in respect of mortgage loans and municipal loans that serve to back mortgage and municipal bonds, or other assets serving as substitute coverage, shall be kept separately by the mortgage bank in its register of mortgages.

Accordingly, mortgage banks shall notify the National Bank of Slovakia and the Ministry of Finance by the end of January and July of each calendar year, and shall report all entries in the register of mortgages for the last six months.

Article 77 of the Act 483/2001 on Banks Coll requires that mortgage banks shall maintain a separate analytical evidence of all the mortgage transactions in their accounting system.

Preferential treatment of covered bond holders

Mortgage bonds do not automatically accelerate when the issuing institution is insolvent. In case of insolvency, the mortgage covered bonds will be repaid at the time corresponding to the original contractual maturity.

The preferential "privilegeright" of the mortgage (municipal) bonds owner is specified in the Act 7/2005 on Bankruptcy and Restructuring Coll.

Mortgage bonds owners and municipal bonds owners shall have preferential "privilege right" to assets used to cover issued mortgage (or municipal) bonds, where the right to lien to real property is included as well.

Owners of mortgage bonds and municipal bonds are "secured creditors" in relation to the mortgage bank based on Act No 7/2005 on Bankruptcy and Restructuring Coll. This Act governs the receivables of mortgage bond owners and the receivables of municipal bonds owners from the mortgage bank for the payment of nominal values and yields of mortgage bonds and municipal bonds.

In case of insolvency of a mortgage bank, a separate substance for the covering of mortgage bonds must be created. The main parts of this substance are mortgage and municipal loans and liens on mortgage and municipal loans. Bondholders, as issuers of mortgage bonds, are protected against claims of other creditors in case of insolvency of banks.

If it is not possible to satisfy the secured claim of a secured creditor, the claim is satisfied as a claim of unsecured creditor. There is a possible recourse to the property of insolvent institutions upon a cover pool default with the unsecured creditors. The use of derivatives in the cover pool is not permitted.

IX. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

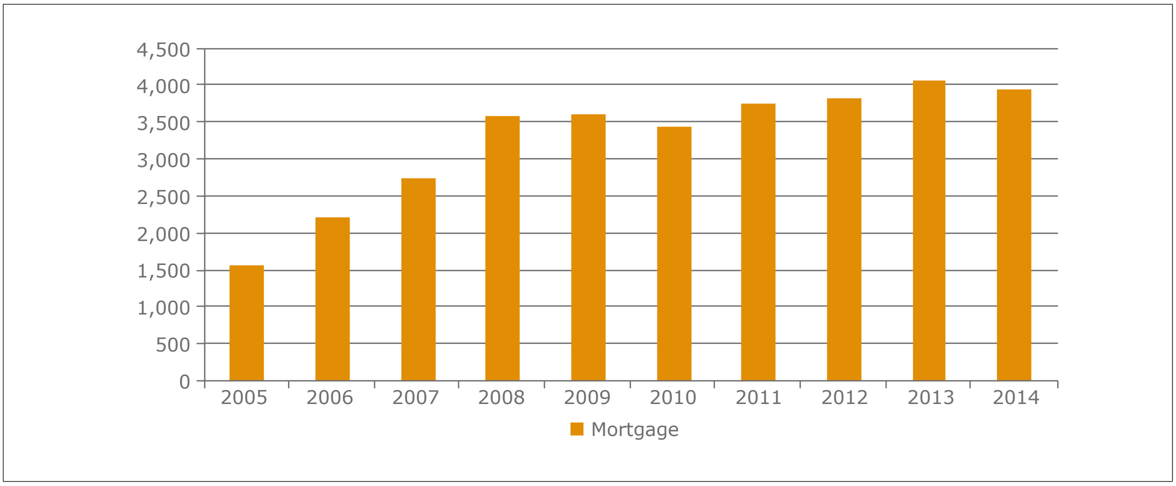
Slovak "*Hypotekárny záložný list*" fully complies with the requirements of Article 52(4) UCITS and Article 129(1) CRR.[2]

The mortgage covered bonds are listed as eligible in REPO transactions with the central bank. Mortgage covered bonds are subjected to special regulations on covered bonds.

As mortgage covered bonds in Slovakia fulfil the criteria of Article 52(4), UCITS-complaint investment funds can invest up to 25% (instead of max. 5%) of their assets in covered bonds of a single issuer. Similar, the EU Directives on Life and Non-Life Insurance (Directives 92/96/EEC and 92/49/EEC) allow insurance companies to invest up to 40% (instead of max. 5%) in UCITS- compliant covered bonds of the same issuer.

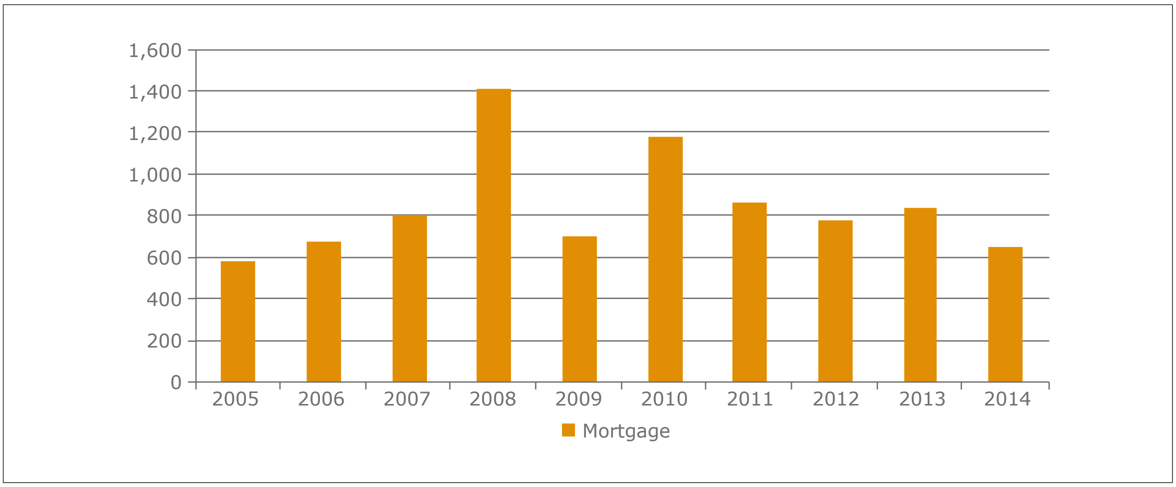
[2] Please click on the following link for further information on the UCITS Directive and the Capital Requirements Regulation (CRR): http://ecbc.hypo.org/Content/default.asp?PageID=504#position. By: Múčková, V., Sobolič, J.: Slovakia. In: European Covered Bond Fact Book. Brussels: Europe Mortgage Federation, 2014, p. 413.

> Figure 1: Covered Bonds Outstanding, 2005-2014, EUR m



Source: EMF-ECBC

> Figure 2: Covered Bonds Issuance, 2005-2014, EUR m



Source: EMF-ECBC

Issuers: CSOB, OTP Banka Slovensko, Prima banka Slovensko, Sberbank Slovensko, Slovenská sporitelna, Tatra Banka, UniCredit Bank (Slovakia) and Všeobecná úverová Banka.

3.30 SLOVENIA

By Damjana Lavrič, Matjaž Grčar, Maja Koritnik; Nova Ljubljanska banka d.d., Ljubljana

I. FRAMEWORK

The legal basis for covered bond issuance in Slovenia is the **Mortgage Bond and Municipal Bond Act** (Official Gazette of the Republic of Slovenia, No. 10/12 and No. 47/12, hereinafter "Covered Bond Act"). Together with the secondary legislation (the regulations of the Bank of Slovenia[1]) outlined below, it represents the legislative framework for mortgage and municipal bonds.

> **Regulation on the conditions for obtaining an authorisation for issuing mortgage and municipal bonds** (Official Gazette of the Republic of Slovenia, No. 17/2012) which regulates in detail the requirements for obtaining an authorisation to issue mortgage and/or municipal bonds;

> **Regulation on matching the cover pool with the outstanding mortgage and municipal bonds** (Official Gazette of Republic of the Slovenia, No. 17/12) which determines detailed rules for matching cover assets and liabilities from issued mortgage or municipal bonds based on the net present value principle, and rules for matching the maturities, interest rate and currency exposure of the cover assets with the liabilities from issued mortgage or municipal bonds;

> **Regulation on the conditions for inclusion of derivative instruments in the cover pool of mortgage and municipal bonds** (Official Gazette of the Republic of Slovenia, No. 17/12) sets out the maximum level of derivative instruments for inclusion into the cover pool, the form of derivative instruments, the type of counterparties and other detailed criteria;

> **Regulation on the documentation for proving the fulfilment of conditions for the cover register administrator appointment** (Official Gazette of the Republic of Slovenia, No. 17/12) regulates the conditions for appointing the cover register administrator[2] of a cover register and for acquiring a Bank of Slovenia's authorisation to act as the cover register administrator of a cover register.

In addition the Bank of Slovenia adopted **Guidelines for managing the records of the cover register** (Governing Board of the Bank of Slovenia, dated 28.2.2012) which set out the guidelines regarding the content, the form and the way of management of the cover register's records.

II. STRUCTURE OF THE ISSUER

The issuer of covered bonds under the Covered Bond Act can be a bank holding a valid banking license issued in accordance with the Banking Act. Further, the issuer must have obtained a license from the Bank of Slovenia for issuing the relevant type of covered bonds (i.e. mortgage bonds, municipal bonds, or both).

In order to obtain the Bank of Slovenia's license for issuing covered bonds, the issuer must prove to the satisfaction of the Bank of Slovenia that it complies with the requirements set out in Article 9 of the Covered Bond Act (detailed provisions set out in Regulation on the conditions for obtaining an authorisation for issuing mortgage and municipal bonds) as outlined below:

> The issuer must have in place systems for managing risks associated with the issuance of the mortgage and municipal bonds, as well as risks associated with cover assets;

[1] The central bank.

[2] Cover register administrator is entitled to verify the accuracy and completeness of the information on the cover assets and covered bonds, measuring compliance with the statutory tests on an on-going basis and approving the entries in and removals of cover assets from the cover register.

> The issuer must ensure an adequate number of qualified employees, be organizationally and technically qualified for issuing mortgage and municipal bonds and to grant mortgage loans, public loans and other financing to legal entities;

> The issuer must ensure that the activities concerning granting mortgage loans and loans to public sector entities and issuing mortgage and municipal bonds are conducted separately from its other business activities;

> The issuer must have in place rules for maintaining the cover register;

> The issuer must have in place the rules for property valuation and must either employ for indefinite period and on full-time basis or engage contractually at least one independent property valuator.

Covered Bond Act envisages the on-balance sheet structure of covered bonds. The cover assets remain the property of the issuer until the insolvency of the issuer or withdrawal of the issuer's license to issue covered bonds. Upon the said events, the cover assets are segregated from the general assets of the issuer and used for repayment of the obligations under the covered bonds in priority to any other assets of the issuer (Covered Bond Act, Articles 15(1) and 45(1)).

III. COVER ASSETS

The cover assets can only be included in the cover pool of covered bonds to the extent that they satisfy the criteria set out in the Covered Bond Act and are free and clear of any lien or other encumbrance.

The cover pool of mortgage bonds may consist of receivables arising from (i) the loans secured by a mortgage on residential property located in the EEA or Switzerland, (ii) the loans secured by mortgage on commercial property located in the EEA or Switzerland (up to 20% of cover assets), (iii) the complementary cover assets (up to 20% of cover assets) and (iv) the derivative instruments (up to 12% of cover assets).

Cover pool of municipal bonds may consist of receivables arising from (i) the loan granted to, or debt securities issued by, an eligible state[3] or eligible local community[4], (ii) the loans granted to, or debt securities issued by, another legal entity provided that the obligations in respect to such loans or securities are guaranteed by an eligible state under an eligible guarantee, (iii) the complementary cover assets (up to 20% of cover assets) and (iv) the derivative instruments (up to 12% of cover assets).

The complementary cover assets may comprise of (i) cash on the account maintained at the Bank of Slovenia, (ii) marketable debt securities issued by an EEA member state and Switzerland (to the extent that its credit rating is equal to or higher than the Eurosystem's credit rating threshold) or its central bank or ECB, or other debt securities issued by EIB, EBRD or other bank according to criterion of ECB.

Issuer can also include the derivative instruments in the cover pool if they reduce risks associated with the cover assets, interest and/or currency mismatches applicable to cover assets and covered bonds.

There are certain other limits concerning the cover assets which comprise the cover pool (Covered Bond Act, Articles 25 and 38(4)):

> Up to 5% of the cover pool may consist of mortgage loans secured by a mortgage on residential property under construction;

[3] Eligible state is an EEA member state and Switzerland, to the extent that its credit rating is equal to or higher than the Eurosystem's credit rating threshold.

[4] Eligible local community is a local community in EEA and Switzerland, to the extent that its credit rating is equal to or higher than the Eurosystem's credit rating threshold.

> Up to 10% of the cover pool may consist of mortgage loans secured by a mortgage the registration of which is still pending, provided that the process of registration is completed within 12 months from the date of filing of the application;

> Up to 20% of the cover pool may consist of mortgage loans to the same person or a group of legal entities which qualifies as a group of affiliated persons in accordance with the Banking Act, without prejudice to the rules on largest exposure applicable under the Banking Act.

IV. VALUATION AND LTV CRITERIA

The level of receivables from mortgage loans that can be taken into consideration for the cover assets must not exceed: (i) 80% of the mortgage lending value of the mortgaged property or, if the issuer decides to use the general market value, 50% of the general market value of property for loans secured by mortgage on residential properties; (ii) 60% of the mortgage lending value of the mortgaged property for loans secured by mortgage on commercial properties. When the level of receivables from mortgage loans exceeds the above restrictions, only an appropriate portion of the loan may be considered as cover assets (Covered Bond Act, Article 28).

The value of the residential and commercial properties can be estimated as the mortgage lending value[5] or market value[6]. Both, the mortgage lending value or market value, are determined by an independent property appraiser in compliance with the international property standards (Covered Bond Act, Article 26(4)). Residential properties can alternatively be estimated also by the use of a general market value appraised by the mass appraisal methods (Covered Bond Act, Article 27). The value of a property is determined individually for each real property (Covered Bond Act, Article 30(1)).

During the property mortgage loan term, the issuer must regularly monitor the value of the mortgaged property and re-assess this value at least once a year for commercial property and at least once every three years for residential property. Issuers may use statistical methods to monitor the value and identify the real property that requires revaluation. Further need for revaluation arises should the value of the real property and the general market prices of the real property in the area where the real property is situated have dropped by more than 20% in the period from the last valuation, or if a borrower is late in meeting his obligations for mortgage loans by more than 90 days (Covered Bond Act, Article 30(4)).

V. ASSET – LIABILITY MANAGEMENT

The issuer may issue mortgage or municipal bonds only to the extent that is necessary to ensure the coverage for liabilities from bonds in circulation and derivative instruments at all times by means of cover assets in at least the same nominal amount (Covered Bond Act, Article 22(1)).

Notwithstanding the provision regarding the nominal amount coverage, the matching of the cover assets with the liabilities from mortgage or municipal bonds and the derivative instruments is ensured at all times according to the present value principle; in this case, the cover assets' present value must exceed the present value of liabilities for mortgage or municipal bonds by at least 2% (Covered Bond Act, Article 22(2)).

The maturities, interest rates and currencies of the cover assets included in the cover register are adjusted to the maturities, interest rates and currency of the liabilities under the covered bonds and the derivative instruments (Covered Bond Act, Article 22(3)).

[5] The mortgage lending value of real property shall be the value of real property as determined on the basis of prudential analysis of the possibilities of selling the property in the future carried out by an independent property appraiser by taking into consideration the long-term sustainability aspects of such property, the usual and the local market conditions, and its current and alternative proper uses without consideration of the speculative elements.

[6] The market value of property is the price determined by an independent appraiser, at which the property could be sold by the seller to the buyer on the basis of a purely commercial relationship, without coercion.

The compliance with the conditions referred to in previous paragraphs must be verified at least once a month.

In addition, stress tests (test of the impact of the change in interest rates and foreign exchange rates) must be performed at least once a month. The issuer must initiate the procedure to increase the cover pool assets should the stressed present value of covered assets not exceed the stressed present value of liabilities of covered bonds by at least 2%.

The issuer must keep cover assets reserves by comparing the amount of matured receivables from cover assets entered in the cover register with the amount of matured liabilities from the issued mortgage or municipal bonds and the matured liabilities from the derivative instruments entered into, on a daily basis over the next 180-day period. Following the comparison of the largest calculated difference between the matured liabilities and the matured receivables, the issuer must provide coverage in the form of complementary assets (Covered Bond Act, Article 23).

VI. TRANSPARENCY

The Slovenian banking sector closely follows the developments regarding the ECBC's and its members' initiatives and trends on transparency. It should be noted that there have been no covered bond issuances from the Slovenian market yet. However, the market initiative on the subject and, in particular, on the national transparency templates is currently being contemplated.

VII. COVER POOL MONITOR AND BANKING SUPERVISION

Obligation to keep a cover register

Issuer must keep a cover register and cannot transfer this task to other persons. The cover register includes the individual entries which represent cover assets for the issued mortgage or municipal bonds. The cover register also includes a record of all the mortgage or municipal bonds issued. The cover register reveals at all times the nominal value of cover assets and mortgage or municipal bonds in circulation (Covered Bond Act, Article 37). Only assets approved by the cover register administrator may be recorded in the cover register or struck off the cover register (Covered Bond Act, Article 38(3)).

When issuing mortgage and municipal bonds, the issuer must keep separate cover registers (Covered Bond Act, Article 51(2)).

Cover register administrator

Every issuer must have a cover register administrator[7] who is independent from the issuer and ensures that the cover register is maintained in accordance with Covered Bond Act, as well as the regulations issued on the basis thereof and performs the other tasks provided for by Covered Bond Act. The cover register administrator is appointed by the issuer (Covered Bond Act, Article 39).

The duties of the cover register administrator are: (i) to ensure that the cover assets provide coverage or the total value of the mortgage or municipal bonds in circulation and liabilities from the derivative instruments; (ii) to ensures the assets are registered in this register; (iii) prior to the issuance of mortgage or municipal bonds, the cover register administrator must confirm that the cover assets provide sufficient and adequate coverage for the bonds; (iii) to consider the issuer's requests for a cancellation of a mortgage as a security for the claims entered as coverage in the cover register; (iv) to forthwith notify the Bank of Slovenia when the cover register administrator determines that the cover assets do not sufficiently cover the mortgage or municipal bonds and liabilities from the derivative instruments, or that they are otherwise contrary to the provisions of

[7] The cover register administrators shall be a person: (i) a certified public accountant who meets the requirements of the act governing auditing or persons with other professional qualifications; (ii) having previously obtained a licence from the Bank of Slovenia to perform the activities of cover register administrator; (iii) whose previous activity raises no doubt as to that person's suitability for the role of administrator (Covered Bond Act, Article 40).

the Covered Bond Act; (v) to regularly notify the Bank of Slovenia of its findings pursuant to the Covered Bond Act (Covered Bond Act, Article 41).

The responsibilities of the cover register administrator are: (i) to examine the books of account and other documents of the issuer that are in any way associated with the mortgage or municipal bonds and cover assets; (ii) to require from the issuer to keep the cover register administrator regularly informed of the performance of the cover asset-related repayments and any other changes associated with these assets (Covered Bond Act, Article 42).

Replacement of inadequate assets

The cover register administrator must require from the issuer to replace the inadequate mortgage loans if: (i) during the term of the mortgage loan, the value of real property declines to such an extent that the value of the outstanding mortgage loan exceeds the mortgage lending value or the real property's general market value level; or (ii) the borrower falls behind in meeting its payment obligations under the loan agreement for over 90 days; or (iii) the issuer receives the cover register administrator's written request related to the expiration of the time limit for entering the mortgage in the land register. In case of a decline in the real property value referred to in item (i), the issuer may supplement the existing receivables from mortgage loans by receivables from other mortgage loans or other suitable assets to the extent of the deficit in the cover assets resulting from a decline in the real property value (Covered Bond Act, Article 31).

Role of the Bank of Slovenia

The Bank of Slovenia supervises the implementation of the Covered Bond Act, grants authorisation to the bank prior to the issuance of the covered bond and grants license to the cover register administrator. In case of the issuer's insolvency, the Bank of Slovenia proposes to the court a cover assets trustee and is authorised to file a request to institute separate bankruptcy proceedings against the cover assets. The issuer and covered bond administrator have to regularly report to the Bank of Slovenia.

VIII. SEGREGATION OF COVER ASSETS AND BANKRUPTCY REMOTENESS OF COVERED BONDS

Segregation of cover assets

The cover assets that comprise the cover pool are evidenced by way of entry in the cover register; while they remain the property of the issuer, they are intended primarily for the payment of obligations under the covered bonds and the derivative instruments that are included in the cover pool (Covered Bond Act, Article 3(1)). Cover assets and complementary assets may not be used or pledged for any other purpose (Covered Bond Act, Articles 19(4) and 20(4)).

The issuer must ensure that the activities in connection with the covered bonds and cover assets are conducted separately from its other business activities (Covered Bond Act, Article 10).

Only the obligations of the issuer under the covered bonds and the derivative instruments can be enforced against the cover assets (Covered Bond Act, Article 37(5)). The law also sets limitations to the set-off rights of the debtors whose liabilities are included in the cover pool (Covered Bond Act, Article 37(6)).

Impact of the issuer's insolvency proceedings and the preferential treatment of the covered bond holders

Upon the issuer's insolvency, the cover pool is separated from the issuer's insolvency estate and the payment of obligations under the covered bonds and the derivative instruments, including the costs, from the cover assets is given priority over all other claims against the issuer (Covered Bond Act, Articles 45(1) and 44(1)). The consequences of the insolvency proceedings do not affect the issuer's obligations under the covered bonds and the derivative instruments (Covered Bond Act, Article 45(2)).

The court designates a cover assets trustee (who is not the same person as the issuer's insolvency administrator) entrusted with the management and disposal of cover assets to the extent necessary for the continuous payment of obligations under the covered bonds and the derivative instruments, for which no approval of the court is required (Covered Bond Act, Articles 46 and 47(1)). The court approval is required for the cover asset trustee's disposal of the cover pool and redemption of the covered bonds prior to their maturity, which is granted if such redemption increases the possibility of repayment of the issuer's obligations under the covered bonds and the derivative instruments (Covered Bond Act, Article 47(3)) – this is the only possible means of acceleration before the maturity of the covered bonds, they do not automatically accelerate in case of insolvency of the issuer nor can they be accelerated at the option of the holders (Covered Bond Act, Article 18).

The issuer's insolvency administrator may request the cover asset trustee to transfer to the issuer's insolvency estate such part of the cover assets that will, beyond any doubt, not be required for the payment of obligations under the covered bonds and the derivative instruments included in the cover pool; the decision on transfer vests with the court (Covered Bond Act, Articles 47(5) and (6). Once all the obligations under the covered bonds and the derivative instruments have been paid, the cover asset trustee transfers the remaining cover assets to the issuer's insolvency estate (Covered Bond Act, Article 47(7)).

Should the cover assets prove insufficient to ensure the continuous payment of obligations under the covered bonds and the derivative instruments, a separate insolvency proceedings are initiated against the cover assets at the request of the Bank of Slovenia; the cover asset trustee can give the initiative to the Bank of Slovenia (Covered Bond Act, Articles 49(1) and (2)). If such separate insolvency proceedings still do not result in full payment of the obligations under the covered bonds and the derivative instruments, the holders of the covered bonds and the creditors under the derivative instruments are entitled to file a claim for the outstanding part of their receivables in the issuer's general insolvency proceedings (Covered Bond Act, Article 49(3)).

Access to liquidity in case of insolvency

The cover asset trustee is entitled to borrow money if this is required to ensure continuous compliance with the payment obligations under the covered bonds and the derivative instruments (Covered Bond Act, Article 47(2)).

Sale and transfer of cover assets to other issuers

Once appointed, the cover asset trustee may transfer the entire cover pool and all obligations arising under the issued covered bonds to a substitute issuer who is willing to assume such rights and liabilities, subject to the prior approval of the Bank of Slovenia (Covered Bond Act, Article 48).

IX. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

The risk-weighting of covered bonds is regulated by two regulations adopted by the Bank of Slovenia, (Regulation on the calculation of capital requirements for credit risk under the standardised approach for banks and savings banks and the Regulation on the calculation of capital requirements for credit risk under the internal ratings based approach for banks and savings banks, both published in the Official Gazette of the Republic of Slovenia, No. 135/06, as amended). The banks using the standardised approach assign the risk-weightings to their covered bond exposures based on the risk weighting of the issuer (e.g. covered bonds of the credit institution with a 20% risk-weighting are assigned a 10% risk-weighting). Under the internal ratings based approach the loss given default (LGD) for covered bonds is set at 11.25%.

The legislation when taken together with the practices, processes and procedures across the industry should fall within the criteria of Article 129 of the Capital Requirements Regulation (CRR). The provisions of the Covered Bond Act fall within the criteria of Article 129(1) CRR as well as the criteria of Article 52(4) of the UCITS Directive.[8]

ECBC Covered Bond Comparative Database: http://www.ecbc.eu/framework/110/Slovenian_Covered_Bonds.

[8] Please click on the following link for further information on the UCITS Directive and the Capital Requirements Regulation (CRR): http://ecbc.hypo.org/Content/default.asp?PageID=504#position.

3.31 SOUTH KOREA

By Hoin Lee, Kim & Chang and Frank Will, HSBC & Chairman of the EU Legislation Working Group

I. FRAMEWORK

Efforts to create a covered bond market in Korea

The Covered Bond Act ("Covered Bond Act") was passed by the National Assembly on December 19, 2013 and came into effect on April 15, 2014. Prior to the enactment of the Covered Bond Act, domestic banks in Korea had been looking at covered bonds as a potential alternative source of funding and the Korea Federation of Banks, a major association of banks in Korea, set up a task force team in 2008 to pursue the introduction of covered bonds in Korea, including by way of a dedicated covered bond statute. Even prior to the Korea Federation of Banks task force team, market participants were looking into alternative structured covered bond structures utilizing Korea's Act on Asset-Backed Securitization (the "ABS Act").

Such efforts eventually led to Kookmin Bank's offshore covered bond issuance in May 2009 (the "KB Covered Bonds"). Kookmin Bank developed a structure on the basis of the securitization techniques under the ABS Act and the Trust Act that enabled the relevant asset pool to be "ring fenced" and effectively granted dual-recourse to its investors through contractual arrangements. The KB Covered Bonds were the first covered bonds issued out of Korea and the Asia-Pacific region.

Many Korean banks looked into possible issuance of similar structured covered bonds after Kookmin Bank's inaugural transaction. Due to the complex structure and favorable market conditions allowing banks to procure funding at acceptable rates, Korean banks did not follow through with covered bond issuance under the Kookmin Bank structured covered bond model.

Separately, in July 2010, the Korea Housing Finance Corporation ("KHFC") issued the second covered bond out of Korea and the first statutory covered bond transaction out of Asia. KHFC utilized the "mortgaged-backed bonds" (the "KHFC Covered Bonds") under the Korea Housing Corporation Act (the "KHFC Act") in issuing the covered bonds. The KHFC Act contemplates various financing options for KHFC and to issue mortgage-backed bonds is one of these options. Mortgaged-backed bonds are economically similar to covered bonds because the bond holders have a statutory priority right over a pool of assets segregated from the other assets of KHFC.

The successful issuance of the KHFC Covered Bonds in 2010 stimulated new interest for covered bonds in Korea, with KHFC Covered Bonds being considered as a potential alternative to traditional residential mortgage backed securities (RMBS) transactions as a funding source for Korean mortgage lenders. Several follow-on transactions have been completed that utilize KHFC as the issuer and the dual recourse feature of mortgage-backed bonds under the KHFC Act.

Following the enactment of the Covered Bond Act, Korean banks are looking into issuing covered bonds in the near future, partly in response to the government's initiatives to encourage banks to find long-term funding source in connection with consumer debt.

II. STRUCTURE OF THE ISSUER

1. KHFC Act

Eligible issuer

KHFC, which is wholly owned by the Korean government and the Bank of Korea, is the only eligible issuer of KHFC Covered Bonds. Pursuant to Article 31 of the KHFC Act, the holders of KHFC Covered Bonds have a statutory priority right of payment from a separately managed pool of mortgage loans designated as the underlying collateral for KHFC Covered Bonds (the "KHFC Cover Pool"). In addition, if principal and interest on a KHFC Covered Bond are not fully paid out of the KHFC Cover Pool, it can be paid from the general assets of KHFC.

KHFC issues these bonds without transferring the cover assets to a separate legal entity and the bankruptcy remote cover assets are left on KHFC's balance sheet.

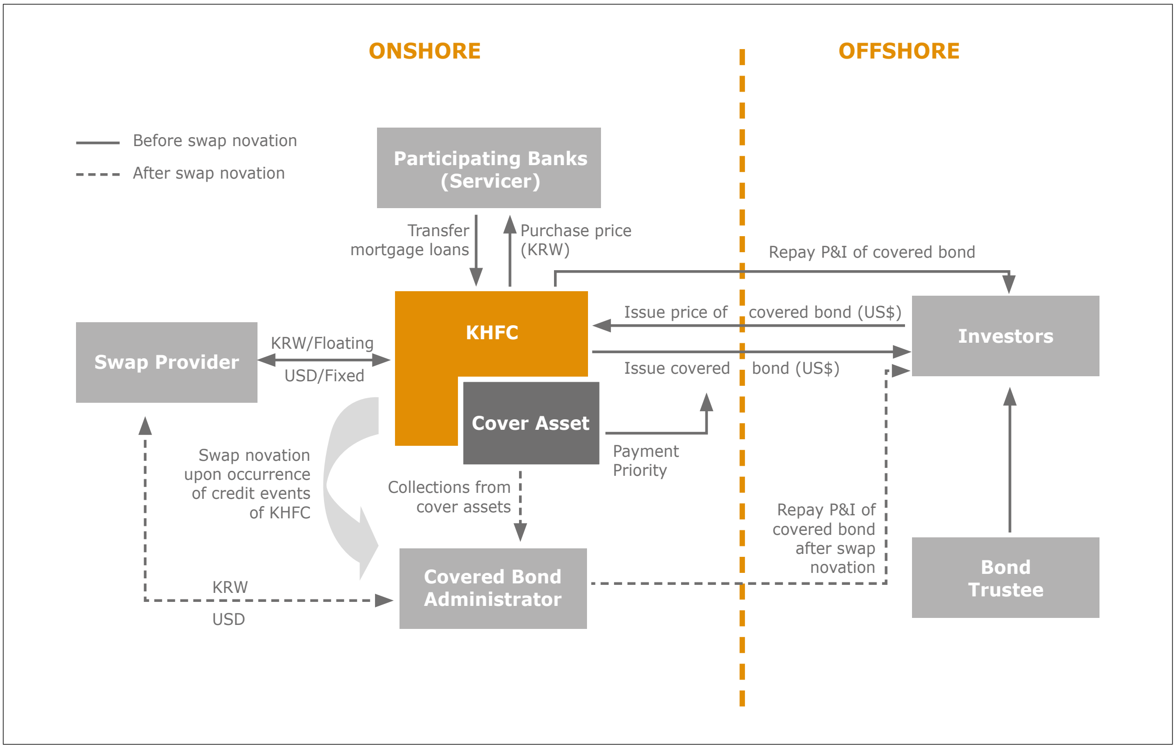
A bond trustee is typically appointed to act on behalf of the investors and an onshore covered bond administrator is appointed for the purpose of the automatic swap novation described below. The investors have dual recourse in respect of the KHFC Covered Bonds: (a) a senior unsecured claim to KHFC upon the occurrence of an issuer event of default or at maturity; and (b) a statutory priority right of payment over the KHFC Cover Pool.

In the case of KHFC Covered Bonds issued offshore, KHFC enters into a cross currency swap agreement and an interest rate swap agreement with the swap providers, pursuant to which KHFC will deliver KRW interest periodically and principal at maturity to the swap providers in exchange for U.S. dollar currency payments. The swap providers pay U.S. dollar interest periodically and principal at maturity. The swap agreement is subject to an automatic swap novation mechanism (the "Swap Novation") in which the swap providers, KHFC, and the covered bond administrator entered into a tripartite automatic novation agreement, which states that the swap agreement will be automatically terminated with KHFC and novated to the covered bond administrator upon the occurrence of certain events of default regarding KHFC, and that the mark-to-market valuation of the swap agreement as of the novation date will not be exchanged between KHFC and the swap providers or between KHFC and the covered bond administrator.

Subsequent to such events of default, the covered bond administrator will pay KRW generated from the KHFC Cover Pool to the swap providers in exchange for the U.S. dollar denominated payments, and the swap providers will pay the U.S. dollar denominated interest periodically and principal at maturity.

The following diagram illustrates the structure of the KHFC Covered Bonds transaction.

FIGURE 1: KHFC COVERED BONDS TRANSACTION STRUCTURE


ONSHORE
OFFSHORE
Before swap novation
After swap novation
Participating Banks (Servicer)
Transfer mortgage loans
Purchase price (KRW)
Repay P&I of covered bond
KHFC
Issue price of covered bond (US$)
Issue covered bond (US$)
Investors
Swap Provider
KRW/Floating
USD/Fixed
Cover Asset
Payment Priority
Swap novation upon occurrence of credit events of KHFC
Collections from cover assets
Repay P&I of covered bond after swap novation
Bond Trustee
KRW
USD
Covered Bond Administrator

Source: Kim & Chang

Issuance limit

KHFC may issue KHFC Covered Bonds up to 50 times of its paid-in equity capital.

2. Covered Bond Act

Eligible issuer

Eligible issuers of covered bonds under the Covered Bond Act (the "Covered Bonds") include (i) banks licensed and established under the Bank Act of Korea, (ii) the Korea Development Bank under the Korea Development Bank Act, (iii) the Export-Import Bank of Korea under the Export-Import Bank of Korea Act, (iv) the Industrial Bank of Korea under the Industrial Bank of Korea Act, (v) NH Bank under the Agricultural Cooperatives Act, (vi) the credit business division of National Federation of Fisheries Cooperatives under the Fisheries Cooperatives Act, (vii) KHFC under the KHFC Act, (viii) the Korea Finance Corporation under the Korea Finance Corporation Act, or (ix) any other company engaging in finance business pursuant to other laws as prescribed by the Presidential Decree of the Covered Bond Act (the "Presidential Decree"). The Presidential Decree came into effect on April 15, 2014 and does not stipulate any additional eligible issuers other than those already set out in the Covered Bond Act. Eligible issuers of Covered Bonds, however, must have equity capital of not less than KRW 100 billion, Bank for International Settlements (BIS) ratio of not less than 10%, and appropriate funding and operation structures and risk management procedures, etc.

Issuance limit

The Covered Bond Act prescribes that eligible issuers may issue Covered Bonds up to the ceiling set by the Presidential Decree which shall not exceed 8% of its total assets as of the end of the fiscal year immediately preceding the scheduled date of issuance and the Presidential Decree limits this to 4% of its total assets as of the end of the fiscal year immediately preceding the scheduled date of issuance. The Financial Services Commission (the "FSC"), which is the main financial regulator in Korea, reserves the right to restrict this further to 2% of its total assets taking into consideration various factors, such as collateralization ratio and financial condition including liquidity position.

III. COVER ASSETS

1. KHFC Act

The mortgage loans in the KHFC Cover Pool are acquired from certain Korean financial institutions that function as the originating banks. The individual mortgage loans included in the KHFC Cover Pool may change from time to time as a result of substitutions by KHFC, and KHFC is responsible for ensuring that the mortgage loans are properly serviced and will delegate its servicing responsibility to the originating banks, with each originating bank servicing those mortgage loans originated and sold by it to KHFC.

2. Covered Bond Act

The cover pool (the "Cover Pool") shall comprise of (1) the Underlying Assets, (2) the Liquid Assets and (3) Other Assets. The "Underlying Assets" shall include (i) residential mortgage loans with 70% or lower loan-to-value (LTV) ratio and first priority mortgage, obligors of which are not subject to insolvency proceedings, (ii) loan receivables against the government, a local government or a corporation incorporated under the special laws, (iii) Korean Treasury bonds, municipal bonds or bonds issued by a corporation incorporated under the special laws, (iv) mortgage loans secured by ships or aircraft with 70% or lower LTV ratio and is insured for an amount in excess of a prescribed minimum level (which is currently 110% of the sum of (a) the aggregate outstanding balance of the relevant loan and (b) any other outstanding debt of the issuer that are at least *pari passu* with such loan) and (v) asset backed securities issued under the ABS Act and KHFC Covered Bonds and residential mortgage backed securities issued pursuant to the KHFC Act. The following limitations are applicable to the residential mortgage loans comprising the Underlying Assets: (x) at least 20% must have a debt-to-income (DTI) ratio of 70% or less, (y) at least 30% must be fixed rate loans, and (z) if there are residential mortgage loans of which 50% or more of their outstanding principal balance may be set off against the relevant issuer, such residential mortgage loans should comprise 10% or less of all residential mortgage loans. The "Liquid Assets" shall comprise of cash, certificates of deposit with a maturity of no more than 100 days issued by financial companies other than the issuer of the Covered Bonds, bonds issued by any government as prescribed by the FSC, financial instruments issued by foreign financial companies as prescribed by the FSC similar to the certificates of deposit referred to above and deposits and term deposits at either domestic or foreign financial companies with maturity of 3 months or less. Finally, "Other Assets" shall comprise of collections and other property rights acquired from the Underlying Assets and the Liquid Assets and the claims acquired from derivatives transactions executed in order to hedge foreign exchange rate or interest rate risks and other risks associated with the cover pool pursuant to the Covered Bond issuance plan.

IV. VALUATION AND LTV CRITERIA

1. KHFC Act

KHFC's detailed rules for the purchase of residential mortgage loans stipulates the requirements of such loans that it can acquire from financial institutions, prescribing that if the DTI ratio is in excess of 60% but no higher than 80%, LTV shall not exceed 60%, while if DTI ratio is 60% or lower, LTV shall be 70% or lower for apartments or 65% or lower for general houses. However, if (i) the grace period is in excess of 1 year; (ii) the interest rate is floating rate; (iii) the credit rating is at or below a certain grade; or (iv) the income for DTI is computed based on estimation, LTV shall be 60% or lower.

There is no statutory standard for valuation of residential mortgage loans that are included in KHFC Cover Pool. Instead, the valuation methods are set forth in individual transaction documents for the KHFC Covered Bonds which value residential mortgage loans between 100% and 0%, depending on the length of delinquency.

2. Covered Bond Act

LTVs for residential mortgage loans as well as loans secured by ships or aircrafts in the Cover Pool shall be 70% or lower. Valuation shall be carried out by reference to the closing market price of the relevant day on the securities exchange. Where no reliable market prices are available on the relevant day, book value, par value, purchase price, transaction price and price provided by an entity which satisfies statutory requirements shall be taken into account, alongside the prevailing exchange rate at the time of valuation. Where derivative transactions have been entered into for the purpose of hedging exposure to movements in foreign currency exchange rates, the exchange rates as specified in such derivative transactions themselves shall be used and non-eligible assets and derivative transactions shall be valued at "0".

V. HEDGING AND ASSET – LIABILITY MANAGEMENT

1. KHFC Act

In the case of KHFC Covered Bonds issued offshore, the underlying residential mortgage loans are denominated in KRW but the KHFC Covered Bonds are issued in foreign currency and KHFC entered into swap agreements to hedge the resulting currency risk. This swap agreement is subject to the Swap Novation described above.

There are no statutory regulations on overcollateralisation or excess yield of collateralized assets. However, the transaction documents in previous KHFC Covered Bonds have required the KHFC Cover Pool to satisfy an asset coverage test and portfolio yield test and the failure for the KHFC Cover Pool to satisfy the foregoing tests for a certain period of time becomes an issuer event of default which in turn triggers the management of the KHFC Cover Pool to be transferred to a separately appointed covered bond administrator, in addition to the above-mentioned Swap Novation.

2. Covered Bond Act

The total value of the Cover Pool shall be equal to or more than 105% (the "Required Overcollateralisation Ratio") of the total value of the covered bonds and the liquid assets shall not exceed 10% of the total outstanding amount of the Cover Pool. The details of the valuation standard and method, etc. for each type of assets comprising the cover pool are prescribed by the Presidential Decree. The issuer shall prepare and maintain separate books for the management of the Cover Pool. If the total value of the Cover Pool is likely to fall below the Required Overcollateralisation Ratio or cover assets fail to satisfy the Cover Pool eligibility criteria set forth in the Covered Bond Act (the "Cover Asset Eligibility"), the issuer shall add or substitute the Underlying Assets and Liquid Assets without delay in order to comply with the Required Overcollateralisation Ratio and the Cover Asset Eligibility. In this case, the relevant assets shall be deemed to form part of the Cover Pool until the relevant assets are substituted.

Unlike the KHFC Act, the claims acquired from derivatives transactions executed in order to hedge foreign exchange rate or interest rate risks and other risks associated with the Cover Pool pursuant to the Covered Bond issuance plan are included in the Cover Pool as described above and the swap provider also has a priority right of payment from the Cover Pool under the Covered Bond Act. As such, we do not expect there to be a particular need to novate the relevant swap agreement to a third party.

VI. TRANSPARENCY

1. KHFC

To issue KHFC Covered Bonds, KHFC must register a securitization plan with the FSC and this securitization plan is available to the public on the FSS website. Amendments to the securitization plan after issuance must also be registered with the FSC.

The securitization plan should include (i) name of KHFC and location of its office, (ii) term of the securitization plan, (iii) the details, total sum and appraisal value of the residential mortgage loans as cover assets, (iv) types, total sum and issuance conditions of the KHFC Covered Bonds to be issued, (v) matters concerning management, operation and disposition of the residential mortgage loans as cover assets, and (vi) matters concerning the covered bond administrator.

2. Covered Bond Act

Any eligible issuer that intends to issue Covered Bonds must register the Covered Bond issuance plan and details of the Cover Pool with the FSC. The issuer must also register amendments to the issuance plan or the matters concerning the Cover Pool, while minor changes shall be reported to the FSC within seven days from the date of such change. The issuance plan should include (i) the terms and conditions of the Covered Bonds, (ii) qualification requirements of the issuer pursuant to the Covered Bond Act such as equity capital, balance sheet, etc., (iii) the details of the Cover Pool, (iv) total valuation amount and details of such valuation of the Cover Pool, (v) the Required Overcollateralisation Ratio, (vi) details of the Cover Pool monitor and (vii) information relating to protection of debtors, details of further issuance of Covered Bonds if relevant, funding plans for redemption of Covered Bonds and other matters relating to issuance, distribution and redemption of Covered Bonds as prescribed by the FSC.

The issuer is required to establish and monitor at least on a quarterly basis separate risk management standards and procedures relating to the issuance and redemption of the Covered Bonds. The issuer is also obligated to disclose on its website on a quarterly basis the result of risk management monitoring, the report prepared by the Cover Pool monitor and other information necessary. The FSC may request data concerning business or properties of the issuer and its administrator and the Cover Pool monitor, or investigate such business and properties if necessary for protecting the Covered Bond investors.

VII. COVER POOL MONITOR AND BANKING SUPERVISION

1. KHFC Act

There are no explicit provisions in the KHFC Act on the KHFC Cover Pool monitor but independent third parties are appointed to supervise and monitor KHFC's management of the KHFC Cover Pool. For example, an accounting firm has been appointed as the cover pool monitor in previous KHFC Covered Bond issuances to be responsible for confirming whether the KHFC Cover Pool minimum maintenance requirements have been satisfied. In addition, the KHFC Covered Bond administrator is appointed in advance for the management of the Cover Pool in order to protect the KHFC Covered Bond holders upon occurrence of any issuer event of default including a bankruptcy event of KHFC.

2. Covered Bond Act

The issuer shall appoint with the approval from the FSC a Cover Pool monitor to monitor the eligibility of the Cover Pool independently. The Cover Pool monitor shall be (i) a person who qualifies as a bond administrator under the Korean Commercial Code, (ii) KHFC (excluding the case where the issuer is KHFC) or (iii) a corporation with equity capital of KRW 1 billion or more that has five or more administration personnel necessary for the performance of duties as a Cover Pool monitor including two or more experts such as lawyers, certified public accountants or certified public appraisers and one or more persons with experience in business related to Covered Bonds.

The Cover Pool monitor is authorized to take any actions in court or otherwise necessary for the management, maintenance and disposition of the Cover Pool. The Cover Pool monitor is obligated to submit on a quarterly basis a report to the FSC within 30 days of the end of each quarter on the performance of its duty as a Cover Pool monitor and provide it to the issuer and, upon request, the Covered Bond investors and other parties, as described below, who have a priority right of payment from the registered Cover Pool.

VIII. SEGREGATION OF COVER ASSETS AND BANKRUPTCY REMOTENESS OF COVERED BONDS

1. KHFC Act

Articles 30 and 31 of the KHFC Act state that (i) KHFC may issue the KHFC Covered Bonds with a statutory priority right of payment over the mortgage loans separately managed in accordance with the applicable KHFC Act securitization plan, and (ii) if mortgage loans in the KHFC Cover Pool are separately managed according to the applicable KHFC Act securitization plan, the investors will have a priority right of payment against such mortgage loans unless otherwise prescribed in other laws. Considering the legislative intent and history of these provisions, the statutory priority right of payment over the mortgage loans owned by KHFC was considered as having been granted to the investors through the registration with the FSC of the applicable KHFC Act securitization plan without taking any other actions necessary for the establishment or perfection of the statutory priority right.

KHFC is required to separately manage the mortgage loans included in the Cover Pool from its other assets on the basis of the applicable KHFC Act securitization plan.

2. Covered Bond Act

Article 13 of the Covered Bond Act states that (i) holders of Covered Bonds, (ii) swap providers, (iii) claimholders relating to the redemption/maintenance and management of the Covered Bonds and management/disposal and execution of the Cover Pool, and (iv) the Cover Pool monitor have a priority right of payment on the registered Cover Pool over third parties. Article 12 of the Covered Bond Act states that, in case of an issuer's insolvency, the Cover Pool shall not be subject to the issuer's insolvency proceedings, including compulsory execution, preservative measures and stay orders. If the principal of the Covered Bonds is not fully repaid, Covered Bond holders have the right to payment from other assets of the issuer in addition to the Cover Pool.

With the consent of the holders of at least 75% of the aggregate outstanding principal amount of the Covered Bonds, FSC may issue an order to transfer relevant contracts to another eligible issuer.

The issuer is required to separately manage the mortgage loans included in a Cover Pool from its other assets on the basis of the applicable issuance plan. The books for the Cover Pool must also be separately maintained and any violation may be subject to criminal sanctions.

IX. RISK-WEIGHTING AND COMPLIANCE WITH EUROPEAN REGULATION

The Covered Bonds under the Covered Bond Act and the KHFC Covered Bonds under the KHFC Act are not compliant with Article 52(4) UCITS, in which case they may not benefit from the higher investment limits because neither KHFC nor any of the potential South Korean issuers of the covered bonds is a credit institution with its registered office in a EU member state. These covered bonds cannot be CRD compliant without meeting the requirements of Article 52(4) UCITS.[1] Thus, the covered bonds cannot benefit from special treatment in terms of risk weighting.

X. ADDITIONAL INFORMATION

There have been 10 covered bond issuances by Korean issuers, four of which were foreign currency denominated covered bonds issued offshore. Apart from the KB Covered Bonds, all the others were KHFC Covered Bond issuances.

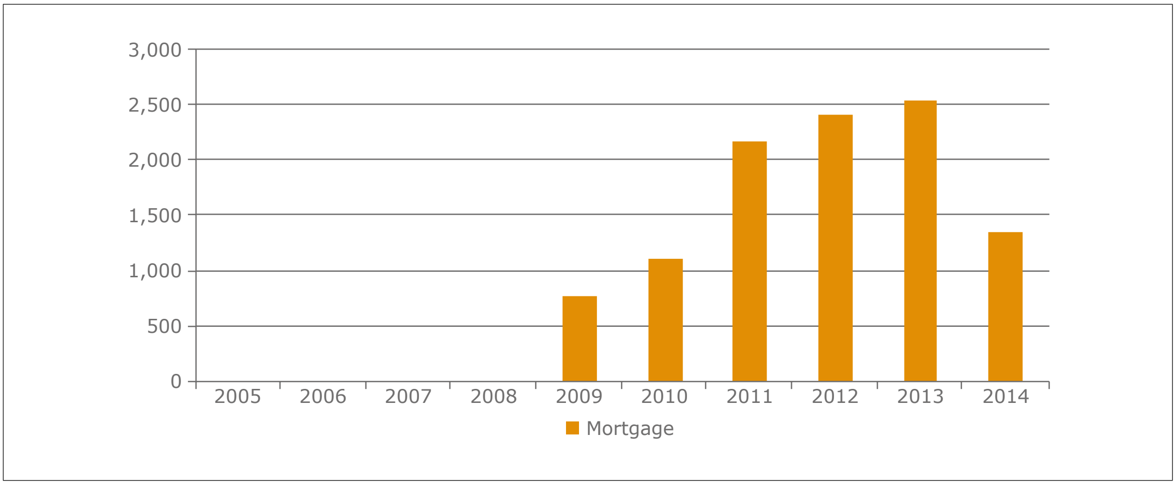
Issuer	Issue Date	Face Amount	Credit Rating	Market
Kookmin Bank	May 14, 2009	US$ 1 billion	AA/Aa2 (S&P/Moody's)	Offshore
KHFC	July 15, 2010	US$ 500 million	Aa3 (Moody's)	Offshore
	April 28, 2011	US$ 200 million	AAA (NICE/KIS)	Onshore
	June 17, 2011	KRW 250 billion	AAA (KR)	Onshore
	July 25, 2011	US$ 500 million	Aa3 (Moody's)	Offshore
	December 8, 2011	KRW 290 billion	AAA (KR)	Onshore
	December 29, 2011	KRW 250 billion	AAA (KR)	Onshore
	March 30, 2012	KRW 250 billion	AAA (KIS)	Onshore
	March 7, 2013	US$ 500 million	Aa1 (Moody's)	Offshore
	March 7, 2013	KRW 150 billion	AAA (KIS)	Onshore

Issuers: Korea Housing Finance Corporation and Kookmin Bank.

ECBC Covered Bond Comparative Database: http://www.ecbc.eu/framework/107/South_Korean_Covered_Bonds.

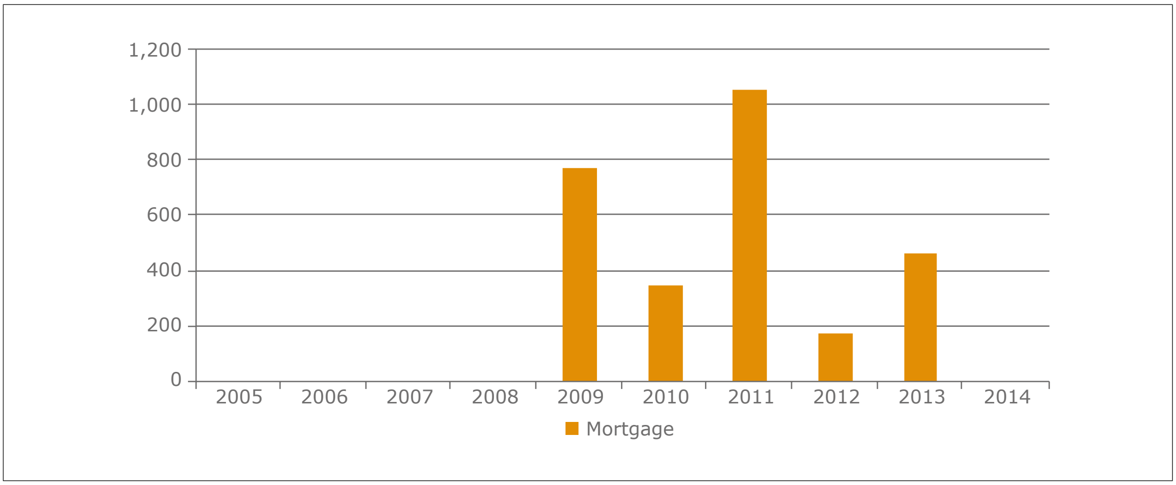
[1] Please click on the following link for further information on the UCITS Directive and the Capital Requirements Regulation (CRR): http://ecbc.hypo.org/Content/default.asp?PageID=504#position.

> Figure 2: Covered Bonds Outstanding, 2005-2014, EUR m



Source: EMF-ECBC

> Figure 3: Covered Bonds Issuance, 2005-2014, EUR m



Source: EMF-ECBC

3.32 SPAIN

By Gregorio Arranz, Spanish Mortgage Association

I. FRAMEWORK

The legal framework for Spanish covered bonds – "Cédulas Hipotecarias" (CHs) – is determined by the Law 2/1981 of 25 March on the regulation of the mortgage market (hereinafter, "Law 2/1981"), Law 41/2007 of 7 December, by which Law 2/1981 of 25 March, regulating the mortgage market and other rules of the mortgage and financial system are modified, reverse mortgages and long-term care insurance are regulated and certain tax regulations are established (hereinafter Law "41/2007") and the Royal Decree 716/2009 of 24 April, which develops certain aspects of Act 2/1981 and other rules of the mortgage and financial system (hereinafter "RD 716/2009"). In May 2013, a new Law on protection of mortgage debtors, restructuring of mortgage debt and rented social housing was approved and partially affected mortgage and procedural laws and some very specific points of Law 2/81 referred below.

Regarding bankruptcy regulation, Article 14 of Law 2/1981 (modified by the 19th final provision of Law 22/2003 of 9 July, hereinafter the "Insolvency Law", and by Law 41/2007) provides for a special treatment for the holders of the CHs in case of insolvency of the issuer. According to this article, CH holders have special privileged claims (*créditos con privilegio especial*) as established in Article 90 of the Insolvency Law.

Article 12 of Law 2/1981 defines that the capital and interests of the CH are secured by the entire mortgage loan book registered in favour of the CH issuer (excl. loans used in securitisations or loans securing mortgage bonds).

Moreover, Article 14 of Law 2/1981 determines that in case of issuer insolvency claims of CH holders shall be treated as privileged claims against the insolvency estate (*créditos contra la masa*). It shall be considered as credits against the mass: all the payments which correspond to the repayment of the capital and interest of the issued cédulas hipotecarias and, if any, to the substitution assets which backup the cédulas hipotecarias and the economic flows generated by the financial instruments linked to the issues (Article of 14 Law 2/1981). Pursuant to Article 84(2)(7), in combination with Article 154 of the Insolvency Law, claims against the insolvency estate have to be paid on their respective due dates without delay of payment, regardless of the status of the bankruptcy proceedings.

In addition, the second additional provision of the Insolvency Law, modified by Royal Decree – Law 3/2009 of 27 March, establishes that in case of insolvency of credit institutions, their specific legislation, specifically Article 10, Article 14 and Article 15 of Law 2/1981 of the mortgage market, shall be applicable. As a result, the mortgage market law supersedes the Insolvency Law.

II. STRUCTURE OF THE ISSUER

Issuers of CHs have to be credit institutions, entitled to participate in the mortgage market and thus, to grant the mortgage credits or loans that comply with the requirements of the Spanish mortgage market legislation. In practice, issuers of CH are mainly: commercial banks, saving banks and cooperative banks.

The issuer of the CHs holds the cover assets on his balance sheet and they are not transferred to a different legal entity.

The CHs, in addition to being direct, unconditional obligations of the issuer and without prejudice to the unlimited universal nature of the liability, comprise a special privileged credit right of its holder against the issuer, and if any, against the substitution assets which backup the cédulas hipotecarias and the economic flows generated by the financial instruments linked to each issue. This right is guaranteed by the entire mortgage loan book registered in favour of the issuer. The effectiveness of this right is also guaranteed by the existence of mandatory over-collateralisation.

Although in 2014 there was not any relevant change in the covered bonds legal framework, it is worth to mention that Spanish regulatory authorities (Treasury, Bank of Spain and CNMV) launched a public consultation on potential changes to the legal regime of CHs. The main topics of the consultation were the following:

a) Possible reduction of the levels of asset encumbrance;

b) Clarification of the rights of cédulas holders in case of insolvency;

c) Introduction of indexation of the cover pool assets;

d) Creation of the figure of the cover pool monitor;

e) Additional liquidity management tools.

Several months after the end of the consultation it seems no legislative measures could be adopted before the general elections due by the end of the year.

Although there is no direct link between the covered bonds and the underlying mortgaged properties, there is a direct link between CHs and the cover assets.

Due to the status of the issuer as a credit institution, one of the requirements to conduct business is to have adequate human and material resources pursuant to the credit institution legislation.

The degree of outsourcing covered bond issuance activities is quite low, almost irrelevant. Usually, the outsourced service has to be provided by a well-known servicer with an adequate rating. In any case, the issuer is responsible and liable for the performance of the service.

Additionally, several entities can group their CHs issuances in a CDO structure (called multi-seller structure). This is based on the issuance of securitisation bonds, backed by the cash-flow generated by such CHs, by an open vehicle that, under Spanish law, is created as a separate fund without legal personality, serviced by a securitisation fund trustee or management company. The bondholders of each of the series issued by the fund will bear the risk of default on the CHs backing the bonds. The holders of these securities, known as "cédulas multicedentes" enjoy all of the advantages of the covered bond but as well of a higher degree of risk diversification.

It is important to point out that there is another Spanish covered bond called Cédulas Territoriales (CTs) with the same special privilege claim status as CHs. In this case, the cover asset pool consists of all loans to the Spanish State, its autonomous communities and local authorities, as well as their entities and dependent public companies and entities of a similar nature in the European Economic Area. The credit institutions may issue CTs up to 70% of the eligible public loan portfolio, resulting in a minimum over-collateralisation of 43%. Later on, the Law 14/2013 of 27 September on support for and the internationalisation of entrepreneurs created the so-called "Cédulas de Internacionalización" and "bonos de internacionalización" which are covered bonds very similar to *cédulas hipotecarias and bonos hipotecarios* (see below) where the cover asset pool consists of loans and credits associated with the financing of export agreements. Secondary legislation was approved by Royal Decree 579/2014 of 4 July but no issuance has taken place yet. The total amount cannot exceed70% of the eligible amounts. Last but not least, a last type of covered bonds is the Bonos Hipotecarios that, although contemplated in Law 2/1981, have not been used for the time being. These bonds have specific mortgages as collateral and not the whole portfolio.

III. COVER ASSETS

A distinction shall be made between cover assets and eligible assets.

Cover assets consists of the entire mortgage loan book registered in favour of the issuer. The special privileged claims of the holders of CHs are guaranteed by the cover asset pool and if any, by the substitution assets which backup the cédulas hipotecarias and the economic flows generated by the financial instruments linked to each issue.

The Law 2/1981 does not establish specific requirements for mortgage loans that constitute the cover asset pool.

For issuance purposes and their limits, it shall be considered as eligible assets in order to determine the maximum amount of CH issued and outstanding for a particular issuer.

All mortgage loans which comply with the following criteria are taken into account for the calculation of the maximum amount of CH issued and outstanding:

> The object of the loan or credit must be the financing of the construction, reconstruction, or acquisition of residential premises, zoning works and social equipment, construction of agrarian buildings, tourist, industrial and commercial and any other activity or work and any other loan, regardless its purpose.

> The mortgage that guarantees the loan or credit must be a first-ranked mortgage.

> The loan or credit guaranteed may not exceed 60% (Article 5 of Law 2/1981 modified by Law 41/2007) of the mortgage lending value of the mortgaged asset, except for the financing of the construction, reconstruction or acquisition of residential premises, in which case it may reach 80% of such value.

> The 80% limit in the ratio between the guaranteed loan or credit and the value of the mortgaged home mentioned in the previous section can be exceeded, without under any circumstances exceeding 95%, if the mortgage loan or credit has a bank guarantee provided by a different credit institution to the creditor or is covered by credit insurance. The bank guarantee or insurance shall be direct and will cover at least the amount of the guaranteed loan or credit which exceeds 80% of the valuation of the mortgaged asset and interests (Article 5 of RD 716/2009). Although the latter is a theoretical possibility as a matter of fact Spanish issuers have never utilized it. Any possible usage should be under the stringent control of Bank of Spain.
>
> Notwithstanding, mortgaged loans or credits that initially exceed these percentages can be used as cover assets for the issuance of CHs when, as a consequence of the repayment of their principal amount or the modification of the market value of the mortgaged properties the values do not exceed said LTV, in relation to the initial or revised valuation of the mortgaged asset.
>
> The mortgaged properties must have been valued previously by the so-called "Sociedades de Tasación" or by the valuation services of the issuer.

> The mortgaged assets must be insured against damages.

> Residential mortgage loan cannot exceed 30 years.
>
> All mortgage loans that do not fulfil at least one of the above mentioned criteria cannot be taken into account for the calculation of the maximum amount of CH.

Excluded from cover asset pool are special types of mortgage credits or loans, such as:

> Those documented by way of registered securities, either to the order or bearer securities.

> Those which are partially or totally due.

> Those which have already been the subject of mortgage participations ("Participaciones Hipotecarias", i.e. loans used in securitisations).

> Those subject to senior mortgages or seizure.

The right to use and enjoy ("derecho de usufructo") administrative concessions, rights to extended areas ("derechos de superficie") and real estate properties which do not have building codes (i.e. those which are outside the zoning regime) are excluded as well.

The cover asset pool is defined as a dynamic cover pool. ABS/MBS or other assets are not allowed in the cover pool, but mortgages are allowed.

It has been a common practice for the issuer to hedge the interest rate risk by using the corresponding derivative instrument.

The institution issuing the cédulas hipotecarias will keep a special accounting register of the loans and credits that serve as collateral of the issues of cédulas hipotecarias and, if any, of the substitute assets fixed that cover them, as well as the derivative financial instruments linked to each issue. The annual accounts of the issuing institution shall contain the essential details of said register (Article 12 of Law 2/1981, Article 21 of RD 716/2009 and Circular 7/2010 of 30 November of the Bank of Spain).

In order to guarantee the transparency of the cover assets, the issuers have to provide the Bank of Spain with a monthly cover pool report. Moreover, there is a general duty of disclosure as a result of the continuous supervisory power of the Bank of Spain.

IV. VALUATION AND LTV CRITERIA

According to mortgage market legislation, the value of the mortgaged property has to be appraised prior to the issuance of the CHs by specialised companies, the so-called *Sociedades de Tasación or by the valuation services of the issuers*.

As said before, for eligible assets, the loan or credit guaranteed may not exceed 60% (Article 5 of Law 2/1981 modified by Law 41/2007) of the mortgage lending value of the mortgaged asset, except for the financing of the construction, reconstruction or acquisition of residential premises, in which case it may reach 80% of such value.

The mortgage markets legislation also determines the regulation for the appraisal service and the requirements with which the specialised companies have to comply, such as, an exclusive corporate object, minimum corporate capital requirement, registration with the corresponding registry at the Bank of Spain. The last legal reform as of May 2013 prevents credit institutions from owning more than a 10% of appraisal companies' capital. Moreover, those entities are supervised and subject to inspection by the Bank of Spain. These rules were developed by the Ministerial Order of 27 March of 2003 in relation to the appraisal of real estate goods.

V. ASSET – LIABILITY MANAGEMENT

The volume of CHs issued and outstanding by a particular Issuer cannot exceed 80% (Article 16 of Law 2/81) of the sum of the unpaid principal amounts corresponding to all the mortgage credits or loans included in the Issuer's portfolio that comply with the requirements mentioned above under section III on cover assets. The issuer cannot issue CHs beyond these percentages at any time.

The cédulas hipotecarias can be backed up to a limit of 5% of the issued capital by substitution assets (fixed income securities issued by the State and other EU Member States, cédulas hipotecarias, mortgage bonds, securities issued by Mortgage Securitisation Funds or Asset Securitisation Funds and other fixed-income securities listed on an official secondary market or on a regulated market, with a credit rating equivalent to that of the Kingdom of Spain – Article 15 and Article 17 of Law 2/1981)

Notwithstanding this general statement, if the limit is surpassed due to increases in the redemption of the Eligible Assets or any other event whatsoever, the Issuer shall re-establish due balance by means of any of the following actions:

> Cash deposit or deposit of government paper in the Central Bank of Spain.

> Acquisition of CHs in the relevant marketplace.

> Execution of new mortgage loans or acquisition of mortgage participations provided that they are eligible to cover CHs.

> Redemption of CHs by the pertinent amount until balance has been reinstated, which, if necessary, can be executed through early redemption and drawing the number of securities to be redeemed by lot.

As a general remark it should be noted that it has been a common practice for the issuer to hedge interest rate risk.

Moreover, regulation provides for some particular rules in this respect that can be summarised as follows: Issuers shall adopt the necessary measures to avoid inappropriate imbalances between the flows from the cover portfolio and those derived from the payments due for the cédulas that they issue (Article 17(6) of RD 716/2009).

Concerning foreign exchange risks, there is no legal provision in relation to the following areas

> The currency of the covered bonds

> Limiting FX risks between cover assets and the CHs

> Limiting, managing or hedging the exchange risk as in the case of the interest rate risk. Notwithstanding, it is universal market practice to denominate the CHs in Euro if the currency of the cover assets is Euro.

Other risks such as early repayment, reinvestment, etc. are also mitigated by the 25% overcollateralisation as well as by the dynamic nature and structure of the cover pool.

VI. TRANSPARENCY

As mentioned above (Section III, Cover Assets) Spanish legislation obliges Spanish issuers of covered bonds to keep a special and very complete register of their loans and credits. The annual accounts have to contain additionally the essential details of said register.

On top of that, main Spanish issuers of CH, coordinated by the Spanish Mortgage Association, and since the end of 2011, have created a transparency template, consistent with the guidelines of the ECBC Label Initiative. This last version meets the requirements of Article 129(7) of the Capital Requirements Regulation (CRR).

VII. COVER POOL MONITOR AND BANKING SUPERVISION

The institution issuing the cédulas will keep a special accounting register. Please refer to Section III on cover assets. The Spanish legislation does not require a special pool monitor other than the supervision on a continuous basis by the Bank of Spain which includes the periodic disclosure of information regarding cover assets by credit institutions.

The Bank of Spain beyond its regular prudential supervision is responsible for specifically supervising compliance with the limits and regulatory requirements and is entitled to adopt measures in order to mitigate any breach or deviation from the regulation, including sanctioning such breach or failure in accordance with Article 5 of Law 26/1988 of 29 July.

The issuer is also responsible and liable for cover and eligible assets pool monitoring. The quantitative mandatory limits have to be maintained at all times, thus the monitoring is carried out continuously by the issuer as a part of the risk management and auditing of its activity.

The “special” supervision – as per reference to Article 52(4) UCITS – is also carried out by the *Comisión Nacional del Mercado de Valores* (hereinafter, “*CNMV*”). The CNMV may also monitor and supervise compliance with statutory requirements and limits upon approval of the issuance and clearly supervise the placing process

The role of the rating agencies shall be decided by the issuer on a case-by-case basis, either for commercial or market reasons, although as matter of fact most issues are rated.

VIII. SEGREGATION OF COVER ASSETS AND BANKRUPTCY REMOTENESS OF COVERED BONDS

Identification of the cover assets

Any mortgage that is originated in Spain must be registered in the Land Registry. Consequently, the Land Registry is the cover registry which records all the mortgages serving as the collateral for the CHs. The institution issuing the cédulas will keep a special accounting register.

Asset segregation from the insolvency's estate

Article 14 of Law 2/1981 of the regulation of the mortgage market stipulates that the institution issuing the cédulas will keep a special accounting register. This provides the legal framework regarding the position of the rights of the holders of the CHs in case of insolvency of the Spanish issuer.

In this respect, it is worth pointing out the following relevant issues:

1. According to Article 14 of Law 2/1981 claims of CH holders have to be treated as privileged claims against the insolvency estate (*créditos contra la masa*). Article 84(2)(7) and Article 154 of the Insolvency Law require that claims against the insolvency estate have to be paid by the insolvency administrators on their respective due dates without delay of payment, regardless of the status of the bankruptcy proceedings.

   In the case of CH, the claims of the CH holders are secured by the entire mortgage loan book registered in favour of the CH issuer (Article 12 of Law 2/1981) and if any, by the substitution assets which backup the cédulas hipotecarias and the economic flows generated by the financial instruments linked to each issue. The definition as stated by the Insolvency Law implies the application of the special rule of payment without enforcement of the collateral.

   The Insolvency administration is not entitled to adopt any decision against said legal provision and has to use the proceeds from the issuer's mortgage loan book to satisfy CH principle and interest payments on their respective due dates without delay of payments.

2. The Insolvency administrators are obliged to pay such amounts as long as the cash flows produced by the cover assets are sufficient to meet the CHs payments pursuant to Article 84(2)(7) of the Insolvency Law.

   In this respect, the Insolvency Law provides a clear definition of the claims of CH holders as special privileged claims without enforcement of the collateral. It also provides an unequivocal classification of the claims of CH holders, as claims against the insolvency estate and clear identification of the cover assets, which are reserved to meet the claims of the CH holders.

   Thus, the clarity of the provision leaves no room for a different interpretation. In other words, the same legal provision that states the privilege, states the extent and limits of the same.

   All of the holders of cédulas hipotecarias, whatever their date of issue, shall have the same preference over the loans and credits covering them and if any, to the substitution assets which backup the cédulas hipotecarias and the economic flows generated by the financial instruments linked to each issue.

3. The payments to be effected by the debtor comprise all those deriving from principal and interest of the issued and outstanding CHs on the date on which the Insolvency is declared. All CH payments have to be met on their respective due dates, regardless of the status of the bankruptcy proceedings. In the case where the cover assets are insufficient to meet the CH payments, the claims of the CH holders will be realised. The payment to all of the cédulas hipotecarias owners shall be done on a pro rata basis, regardless of the issue date of their securities. (Article 14 of Law 2/1981). In the case of insufficient cover assets, all CH holders' claims will be met on a pro-rata basis together with ordinary claims (Article 157(2) of the Insolvency Law).

   A judicial stay (moratorium) on the insolvency's estate cannot delay the cash flows from the cover assets and, therefore, endanger the timely payment of interest and the principle on CHs.

In case of insolvency of the issuer, liquidity is ensured by the means discussed above, by the flows derived from the cover assets.

In order to comply with the payment obligations to the holders of the cédulas hipotecarias in the event of a temporary gap in the revenue received by the debtor, payments shall be made by means of liquidating the substitution assets serving as collateral of the issue. If this was insufficient, payments shall be made by means of funding operations via subrogation of the debtor in the position of the holder of the cédulas (Article 14 of Law 2/1981).

Administration of the cover assets

In case of insolvency, it is the normal insolvency administrator who administrates the cover assets. In this respect, under Spanish Insolvency Law, the bankruptcy is directed by commercial court of competent jurisdiction and managed by a specific body called the "bankruptcy authority" ("administración concursal") normally comprising a single person.

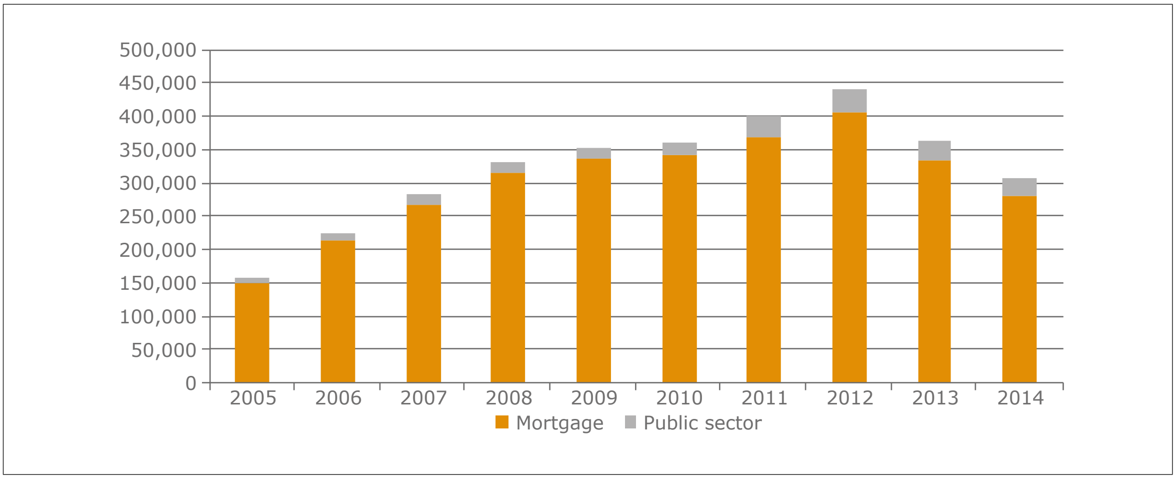
IX. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

The legislation when taken together with the practices, processes and procedures across the industry should fall within the criteria of Article 129 of the Capital Requirements Regulation (CRR). The Spanish covered bonds fulfil the criteria of Article 52(4) UCITS and Article 129 CRR.[1]

Finally, the CHs upon being listed or applied for listing are eligible for: i) investment by insurance companies of their technical provisions obligations; ii) the investment by mutual guarantee companies; iii) investment by Pensions Funds.

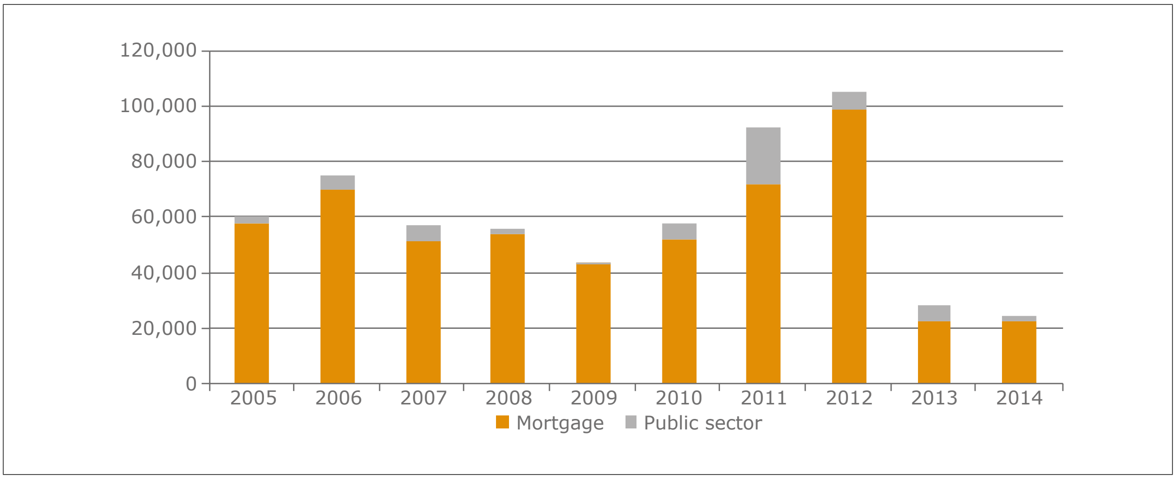
[1] Please click on the following link for further information on the UCITS Directive and the Capital Requirements Regulation (CRR): http://ecbc.hypo.org/Content/default.asp?PageID=504#position.

> Figure 1: Covered Bonds Outstanding, 2005-2014, EUR m



Source: EMF-ECBC

> Figure 2: Covered Bonds Issuance, 2005-2014, EUR m



Source: EMF-ECBC

Issuers: Banca March, Banco Caja Castilla La Mancha, Banco Caminos, Banco de Sabadell S.A., Banco Mare Nostrum, Banco Popular, Banco Popular e.com, Caja Rural de Granada, Banco Santander S.A., Banesto, Bankia, Bankinter, Bankoa, Barclays Bank, BBVA, C. Pollença, CaixaBank SA, Caja Laboral, Caja Rural Navarra, Caja Tres, Cajas Rurales Unidas, Cajasur, Catalunya Bank, CEISS, Deutsche Bank SAE, Ibercaja, Kutxabank S.A., Liberbank, Santander Consumer Finance, Unicaja Banco, Novobanco, Abanca.

ECBC Covered Bond Comparative Database: http://www.ecbc.eu/framework/45/C%C3%A9dulas_Hipotecarias.

Covered Bond Label : Banco de Sabadell, S.A.; Banco Popular Español; Santander Mortgage Covered Bonds; Bankia Mortgage; Bankinter, S.A.; BBVA Covered Bond Programme; BBVA Public Sector Covered Bond Programme; Mortgages Loans Caixabank S.A.; Public Loans CaixaBank S.A.; Kutxabank S.A.; Unicaja Banco Mortgage Covered Bonds; Ibercaja Banco S.A.

3.33 SWEDEN

By Jonny Sylvén, Association of Swedish Covered Bond Issuers (ASCB)

I. FRAMEWORK

In Sweden, the issuance of covered bonds is governed by the Swedish Covered Bonds Issuance Act, which came into force on 1 July 2004 (Lag 2003:1223 *om utgivning av säkerställda obligationer*, hereinafter the 'CBIA')[1]. The CBIA supersedes the general bankruptcy regulation and grants covered bond investors a priority claim on eligible cover assets (CBIA: Chapter 4, Section 1). A new regulatory provisions (FFFS 2013:01, hereinafter 'CBR')[2] established by the Swedish Financial Supervisory Authority (Finansinspektionen, hereinafter 'SFSA') complement the legislation. These regulations define in more detail the criteria for obtaining an issue licence, the universe of eligible cover assets, valuation procedures for eligible cover assets, asset and liability management, and the form and maintenance of the cover register.

II. STRUCTURE OF THE ISSUER

The CBIA does not apply the specialised banking principle but allows all banks and credit institutions to issue covered bonds provided they have obtained a special licence from the SFSA (CBIA: Chapter 2, Section 1). The issuer must meet certain criteria to qualify for the licence. These criteria include the submission of a financial plan proving the issuer's financial stability for the next three years, the conversion of outstanding mortgage bonds into covered bonds, and the conduct of business in compliance with the CBIA. The SFSA has the right to withdraw the licence should the institution be in material breach of the CBIA or have failed to issue covered bonds within one year of receiving the licence (Figure 1). If the SFSA withdraws a licence, the authority may determine a plan to wind down the operation.

> Figure 1: Licence needed to issue covered bonds

Requirements for issuance licence:

- The institution's articles of association, by laws or regulations must comply with the CBIA.
- The issuer must conduct the covered bonds business according to the CBIA and related regulatory provisions.
- Outstanding mortgage bonds to finance loans that may be included in the covered pool must be converted into covered bonds or administered in an equivalent manner with respect to the creditors.
- The issuer must submit a financial plan for the next three financial years indicating that it is sufficiently stable so that the interest of other creditors is not jeopardised when it issues covered bonds. The report must be substantiated by auditors.
- The issuers must submit an operational plan that calls for sound management and supervision of the covered bond business (including information of the IT business).

The SFSA may withdraw a licence if:

- The institution is in material breach of its obligations pursuant to the CBIA; and/or
- The institution has failed to issue a covered bond within one year of receiving the licence.

Source: Lag 2003:1223, FFFS 2013:01

[1] Lag 2003:1223 om utgivning av säkerställda obligationer [Covered Bonds Issuance Act].

[2] FFFS 2013:01 Finansinspektionen's Regulations and Guidelines regarding covered bonds.

Prior to the CBIA, commercial banks were restricted on their mortgage lending activities, and mortgage loans were extended by specialised mortgage institutions, which were allowed to issue mortgage bonds. Most of the Swedish mortgage credit institutions have a strong affiliation with Nordic universal banking groups, outsourcing their activities to their respective parent. The degree of outsourcing varies among issuers. The SFSA has published general requirements regarding outsourcing.

The cover assets represent claims of the covered-bond-issuing entity and remain on the balance sheet. There is no subsequent transfer of cover assets to another legal entity. The covered bonds are direct, unconditional obligations on the part of the issuer. Outstanding covered bonds are backed in their entirety by the cover pool. Hence, there is no direct legal link between single cover assets and particular covered bond series. In the event of issuer insolvency, the cover pool is bankruptcy-remote from the general insolvency estate of the issuer and exclusively available to meet outstanding claims of covered bond holders. Moreover, covered bond investors enjoy ultimate recourse to the insolvency estate of the issuer, ranking pari passu with senior unsecured investors.

III. COVER ASSETS

Eligible cover assets are mortgage loans and public-sector assets (CBIA: Chapter 3, Section 1). The CBIA does not specify separate cover pools for mortgage and public sector cover assets. Both asset classes are mixed in one cover pool. However, the main emphasis of Swedish issuers is on mortgage covered bonds (more than 90 percent of cover pools).

Eligible assets are mortgages:

> on real estate intended for residential, agricultural, office or commercial use;

> on site-leasehold rights intended for residential, office or commercial use;

> pledged against tenant-owner rights; and

> against similar foreign collateral.

The CBIA restricts mortgages against offices and commercial property to 10% of the total cover pool. Mortgage loans can be secured only with collateral comprising property located in Sweden and the European Economic Area (EEA)[3]. Neither asset-backed securities nor mortgage-backed securities are permissible as cover assets. The mortgage loans must meet valuation procedures and certain loan-to-value ratios defined by the CBIA and the CBR (see section IV).

Eligible public-sector assets are defined as securities and other claims:

> issued by or guaranteed by the Swedish state, Swedish municipality or comparable public body;

> issued by or guaranteed by a foreign state or central bank, where the investment is in the foreign state's currency and is refinanced by the same currency[4];

> issued by or guaranteed by the European Communities, or any of the foreign states, or central banks as prescribed by the Swedish government; or guaranteed by a foreign municipality or public body that has the authority to collect taxes.

The cover pool is a dynamic pool, and non-performing loans due over 60 days cannot be recognised for the purposes of meeting the matching requirements set forth by the CBIA (CBR: Chapter 3, Section 4).

[3] Countries belonging to the European Economic Area are the 27 EU countries plus Norway, Iceland, Liechtenstein.

[4] The law does not provide for any explicit geographic restriction.

Derivative contracts

The CBIA provides for the use of derivatives for hedging interest and currency risk. The derivatives must be structured such that premature termination is not triggered by an issuer default or on demand of the counterparty. Derivative counterparties must have a minimum long-term rating of A3/A-/A- (Moody's/ S&P/Fitch) at the time the agreement is entered into. The law stipulates asymmetrical collateralisation, in that it requires collateral, a guarantee or replacement language in the event that the counterparty's rating falls below the minimum rating level. There is no reciprocal requirement by the covered bond issuer, given that derivative counterparties have a priority claim on the cover pool (CBR: Chapter 4, Sections 5 to 7). The use of derivatives is not limited to a maximum percentage of the cover pool since they are not included in the nominal matching calculation. Their use is limited to serve the balance between cover assets and outstanding covered bonds when creating a balance in respect of net present value of assets and liabilities.

Substitute assets

Highly liquid assets can serve as substitute assets for up to 20% of the mortgage cover pool. The SFSA can temporarily raise the limit to 30%. Eligible substitute assets include eligible public sector assets plus cash, cheques and postal money orders. These assets qualify for a 0% risk weighting. The SFSA has the discretion to extend the universe to eligible substitute assets (CBIA: Chapter 3, Section 2).

IV. VALUATION AND LTV CRITERIA

The CBIA defines valuation principles for properties that act as collateral for mortgages in the cover pool (CBIA: Chapter 3, Section 4). The valuation relating to residential properties may be based on general price levels. The valuation of any other eligible property class must be based on the market price, which must be determined by individual appraisal by qualified professionals. The market value should reflect the price achievable through a commercial sale, without time pressure and excluding any speculative or temporary elements. Issuers must monitor the market value of the property regularly, and in the case of serious decline must review the valuation, and ensure that the loan to value (LTV) of the related mortgage loan remains within the defined maximum limit (CBR: Chapter 3, Section 7, Chapter 5, Section 4). The valuer is normally an employee of the issuer, but external valuers are also used.

For the various mortgage types eligible as cover, the following maximum LTV ratios apply (CBIA: Chapter 3, Section 3):

> 75% of the value for real estate, site-leasehold rights and tenant-owner rights where the property is intended for residential use;

> 70% of the value for real estate intended for agricultural use;

> 60% of the value for real estate, site-leasehold rights and tenant-owner rights where the property is intended for office or commercial use.

These LTV limits are relative, not absolute, limits. A loan with a higher LTV ratio can be included in the cover pool up to the legal threshold. The balance must be refinanced with other funding instruments (e.g., senior unsecured funding) (CBR: Chapter 5, Section 3).

An issuing institution shall test and analyse how changes in property values may affect LTV ratios and the value of the cover pool. These tests shall at least be performed once a year. The tests should be based on conservative assumptions.

V. ASSET – LIABILITY MANAGEMENT

The CBIA requires that the nominal value of the cover assets all times exceeds at the aggregate nominal value of claims arising from outstanding covered bonds against the issuer (CBIA: Chapter 3, Section 8). In addition, the law requires that on a net present value (NPV) basis, cover assets, including derivatives, always exceed the corresponding value of the interest and principal of outstanding covered bonds, taking into account the effects of stress-test scenarios on interest and currency risk set by the SFSA. The SFSA defines the stress test for interest-rate risk as a sudden and sustained parallel shift in the reference swap curve by 100bps in an unfavourable direction, and a twist in the swap curve. Likewise, it defines currency risk as a 10% sudden and sustained change in the relevant foreign exchange rate between the currency of covered bonds and the currency of cover assets (CBR: Chapter 4, Section 3-5). The CBIA does not require a mandatory level of minimum overcollateralization (OC). However, the issuer can adhere to a self-imposed OC level for structural enhancement, as the CBIA protects any OC in the cover pool in the event of issuer insolvency.

Finally, the issuing institution shall ensure that the cash flow with respect to the assets in the cover pool, derivatives agreements and the covered bonds are such that the institution is always able to meet its payment obligations towards holders of covered bonds and counterparties in derivatives agreements (CBIA: Chapter 3, Section 9). The issuer should be able to account for these funds separately.

VI. TRANSPARENCY

The issuers are presenting information regarding their cover pool and outstanding covered bond every quarter in line with the national transparency template. The information is today on every issuers' websites. Some of the issuer report more frequent then quarterly. The content of the national transparency template (posted on the Covered Bond Label website[5]) will be expanded if there are requests for it. Adaptations have been made to the requirements in the Capital Requirements Regulation (CRR). The information in the national transparency template will at least be what is required in CRR. Most of the issuers in Sweden have a special company that issue bonds. Those companies present quarterly or semi-annual reports. Those reports have information regarding the company and its business. The issuer is required to feed the independent inspector with all kinds of information with a rather tight frequency. According to the new regulation from the Swedish FSA this year that information will be more detailed.

VII. COVER POOL MONITORING AND BANKING SUPERVISION

The covered bond issuers fall under the special supervision of the SFSA. The financial regulator monitors the institutions' compliance with the CBIA and other related regulatory provisions (e.g., CBR). If the covered bond issuer is in material breach of its obligations under the legal framework, the SFSA can issue a warning or revoke the issue license altogether. The SFSA may also revoke a license if the institution has declared that it waives the license or if the institution has not made use of the license within a year from the date of receiving the license. The revocation may be combined with an injunction against continuing the operations and with the imposition of a conditional fine. In any case, the SFSA must determine how the operations should be wound up (CBIA: Chapter 5, Sections 2 to 6).

For each issuing institution, the SFSA must appoint an independent and suitably qualified cover pool inspector (cover pool trustee), who is paid by the covered bond issuer. The duties of the cover pool inspector are to monitor the register and verify that covered bonds, derivatives agreements and the cover assets are correctly recorded. The inspector also ensures compliance with matching and market risk limits in accordance with the CBIA. The inspector must also, nowadays, review the revaluations of underlying collateral that has been conducted during the year. The institution is obliged to provide the covered bond inspector with any information requested relating

[5] https://www.coveredbondlabel.com/issuers/national-information-detail/24/.

to its covered bond operations. The cover pool monitor must submit a report of the inspection to the SFSA on an annual basis, and must notify the SFSA as soon as he/she learns about an event deemed to be significant to the supervisory authority (CBIA: Chapter 3, Section 12 to 14, and CBR: Chapter 6).

VIII. SEGREGATION OF COVER ASSETS AND BANKRUPTCY REMOTENESS OF COVERED BONDS

Cover register

The issuer must keep a register of eligible cover assets, substitute assets, derivative contracts, and outstanding covered bonds (CBIA: Chapter 3, Section 10). The law specifies the form and content of such a register, which must be easily accessible for the SFSA and the cover pool inspector. The registration legally secures covered bondholders and derivative counterparties a priority claim on the cover pool in the event of issuer insolvency (CBIA: Chapter 4, Section 4). Prior to an issuer being declared insolvent, cash flows accruing from the cover assets must be accounted for separately by the issuer. In the event of issuer default, covered bond investors and derivative counterparties have the same priority claim on these funds as they have on the cover pool. Moreover, cash flows accruing from the cover assets after issuer insolvency must be registered in the cover pool register.

Issuer is a subsidiary

Under the Swedish bankruptcy code, the mere insolvency of the parent company does not automatically trigger the insolvency of a subsidiary.

Issuer insolvency

In the event of issuer insolvency, the registered cover assets and the respective covered bonds are segregated from the general insolvency estate. Covered bonds are not accelerated as long as the cover pool fulfils the requirements set out in the CBIA, notwithstanding the existence of 'only temporary, minor deviations' (CBIA: Chapter 4, Section 2).[6] Also, mere issuer default does not trigger the premature termination of registered derivative contracts. Covered bond holders and registered derivative counterparties have a priority claim on the cover pool and cash that derives from the pool, ensuring timely repayment to original agreed terms, as long as the pool complies with the CBIA. However, the cover pool does not constitute a separate legal estate. According to legal opinion, the bankruptcy of the issuer should not lead to a debt moratorium on covered bonds.[7]

Cover pool insolvency and preferential treatment

In the event that the cover pool breached eligibility criteria, covered bonds would be accelerated. Covered bond investors and derivative counterparties would have a priority claim on the proceeds from the sale of the cover assets, ranking pari passu among themselves but prior to any tax claims and salary payments (pursuant to Section 3a of the Rights of Priority Act [SFS 1970:979]). If the proceeds are insufficient to repay all liabilities on outstanding covered bonds, covered bond investors and derivative counterparties would have an ultimate recourse to the insolvency estate of the issuer, ranking pari passu with senior unsecured investors.

Survival of OC

Any OC present in the cover pool at the time of issuer insolvency is bankruptcy-remote provided it is identified in the cover pool register. Indeed, the CBIA requires full repayment of outstanding claims on covered bonds, and registered derivatives, before cover assets would be available to satisfy claims on unsecured creditors.

[6] According to preparatory works to the Act, this would be, for example, "temporary liquidity constraints".

[7] There are no means in the Act that could disrupt or delay payment to covered bondholders. However, the Act does not explicitly derogate from the general provision of the Code of Procedures 1948 or the Bankruptcy Act 1987, of which neither explicitly ensures the integrity of payments on covered bonds.

The law does not provide for the appointment of a special cover pool administrator. The receiver-in-bankruptcy represents the interests of both the covered bond investors and the unsecured investors. The receiver has the right to use OC to pay advance dividends to other creditors of the bankrupt issuer, if the pool contains more assets than necessary.[8] If the cover assets later prove to be insufficient, these advance dividend payments can be reclaimed.

Access to liquidity in case of insolvency

In the cases of issuer insolvency, the law does not enable the receiver-in-bankruptcy to refinance maturing covered bonds of the issuing institution by issuing new covered bonds against the cover pool. Likewise, the receiver is not able to substitute ordinary cover assets for alternative assets. However, the receiver can use available liquid substitute assets included in the pool. In addition, the receiver can sell part of the cover pool in the market to create the necessary liquidity without raising debt.

The receiver-in-bankruptcy has – as of the 1 June 2010 – also got an express mandate, on behalf of the bankruptcy estate, to take out liquidity loans and enter into other agreements for the purpose of maintaining matching between the cover pool, covered bonds and derivative contracts. The receiver has an extensive mandate to enter into agreements, not only to achieve a liquidity balance but also to achieve a balance in respect of currencies, interest rates and interest periods. The receiver should only enter into agreements if, on the date of execution of the agreement, the agreement is deemed to favour bondholders and derivative counterparties and if the assets in the cover pool are deemed to fulfil the terms and conditions imposed in the Act. When the receiver enters into an agreement, the contracting party receives a claim against the bankruptcy estate that ranks ahead of the secured creditors and creditors with rights of priority.

IX. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

The legislation when taken together with the practices, processes and procedures across the industry should fall within the criteria of Article 129 CRR. Swedish covered bonds comply with the criteria of article UCITS 52 (4) UCITS and with the covered bond criteria defined in article 129 in CRR.[9] Because of the bonds compliance with article 129 in CRR, the risk- weight for the Swedish covered bonds will be as is stated in article 129 for banks that use the standard method. The CBIA explicitly lists mortgages against property for agricultural purposes, and mortgages against the pledging of tenant-owner rights as eligible cover assets, while the CRR does not. However, general opinion of the parties involved is that the EU CRR's term "commercial real estate" should be interpreted in a broader sense, including agricultural property. In addition, issuers can impose self- restrictions to ensure that their covered bond issues comply with the CRR. Swedish covered bonds are eligible for repo transactions with the Riksbank (the Swedish Central Bank). The share of the total collateral in relation to the payment system that can be comprised of covered bonds is 100 % per cent. This applies to covered bonds issued by the borrower or by an institution with close links to the borrower.

The Riksbank's collateral requirements are harmonised with those applied within the Eurosystem. Moreover, Swedish covered bonds denominated in euros are likely to qualify as Tier 1 assets with the ECB.[10]

Foreign covered bonds enjoy the same preferential capital treatment in Sweden, if the foreign supervisory authority of that covered bond issuing institution has also assigned those covered bonds preferential risk- weightings (principle of mutual recognition).

[8] According to legal opinion, the receiver-in-bankruptcy would have to take into account a substantial safety margin to ensure that the cover pool's integrity and compliance with the Act is not jeopardized, which would be difficult to prove unless outstanding covered bonds were due to mature imminently.

[9] Please click on the following link for further information on the UCITS Directive and the Capital Requirements Regulation (CRR): http://ecbc.hypo.org/Content/default.asp?PageID=504#position.

[10] In general, the ECB grants marketable debt instruments the status of Tier 1 assets, if the security is denominated in euros, compliant with UCITS Art. 552 (4) and issued by a credit institution situated in the EEA area (ECB: "Implementation of Monetary Policy in the Euro Area", Feb, 2005).

The law regulating insurance companies in Sweden (Försäkringsrörelselagen 1982:713) makes no distinction between mortgage bonds and covered bonds. Swedish insurance companies can invest up to a maximum of 25 % in the covered bonds of a single issuer. Swedish legislation on investment funds (Lag 2004:64 om investeringsfonder) allows mutual funds to invest up to 25% of their assets in Swedish covered bonds, instead of the 10% generally applicable to other asset classes.

X. ADDITIONAL INFORMATION

Issuing and trading of Swedish domestic covered bonds

In order to issue covered bonds mortgage companies and banks need an authorisation by the Swedish Financial Supervisory Authority (SFSA). Normally the bonds are registered at the Nordic Exchange Stockholm (NASDAQ OMX Group), although no actual bond trading takes place there. Offering circulars with the detailed issue conditions are following a standard based on the Prospectus Directive with acceptance from the SFSA, OMX and the market makers. The normally used technique for issues is "on tap".

The Swedish bond market investors appreciate liquidity. Because of these "requirements" the large issuers issue their bonds as benchmarks which mean that large amounts (SEK 3 billion and more) are issued and that a number of dealers, under normal circumstances, show both bid and offer prices. Also, only benchmarks are deliverable in the future contracts. When a new benchmark-loan is issued, the issuers make sure that the amount issued meets the requirements for a benchmark sized deal. After the initial day of issuance the issuer can, without further notice, issue "on tap" the size he requires to match the lending.

The bonds are sold into the primary market through banks acting as agents for the issuer. These banks also act as market makers in the secondary market. Currently, there are five banks that act as market makers in covered bonds: Danske Bank, Nordea, SEB, Svenska Handelsbanken and Swedbank. The market for government and domestic covered bonds, as well as treasury bills, is a telephone and screen-based over-the-counter market. Market makers display indicative two-way prices on an electronic information system which is instantaneously relayed by Reuters. Fixed prices are quoted on request and most deals are concluded via telephone. Trading in the secondary market takes place on all business days between 09.00 and 16.15 (local time). The number of bonds to be quoted is regulated in an agreement between the issuer and the market-maker.

Bonds are quoted on a yield basis with bid and ask spread of (under normal market conditions) 2 bp for the liquid benchmark bonds. The settlement day for bonds is three business days after the trading date. T-bills are quoted on a simple yield basis and are settled two business days after the trading day. The normal trading lot in government securities and liquid mortgage bonds is SEK 200-500m. Of course, prices are given for other lots as well.

Sweden has a liquid and smoothly operating repo market with almost all banks and broker firms involved in the trading. The repo market in Sweden started in the late 1980s, and has developed fast. The Swedish Debt Office offers a repo-facility in government bonds and treasury bills and mortgage companies offer their market makers a repo-facility in their own bonds. The repo transaction is viewed as a 'sell-buy back' or 'buy-sell back' deal and the ownership of the security has to be transferred. There are no standard conditions for a repo transaction and the counterparties have to agree on maturity, settlement day and delivery for each deal. Most often, though, repos are settled two banking days after the trading day. Repo rates are quoted as a spread vs the Riksbank repo rate.

Almost all public listed securities in Sweden are registered at the Euroclear Sweden. In general, Swedish bonds are domestically settled via the Euroclear. Domestic settlement requires a custodian account with one of the Swedish banks or securities firms. Foreign investors can either have a custodian service with a Swedish bank or securities firm or settle via Euroclear or Cedel.

Accrued interest is calculated from the previous coupon date to the settlement day. The interest rate is calculated by using ISMA's 30E/360 day count – "End-of-month" convention.

Swedish government and covered bonds have five ex-coupon days which means that there is negative interest when settlement occurs within five business days before the coupon date.

Most Swedish bonds pay coupon annually. There are, however, bonds that pay coupon semi-annually. All domestic banks act as paying agents.

Swedish krona bonds redeem at par upon maturity.

The activities of ASCB

The Association of Swedish Covered Bond issuers (ASCB), which was established in 2009, has an ongoing work to further improve the conditions for the Swedish covered bonds. Two recent results of these efforts are firstly an amendment of the law with the purpose to grant the receiver-in-bankruptcy access to short-term liquidity in case of insolvency (see chapter VII) and secondly an agreement on the method of calculating the LTV for the cover pool.

Further information concerning the road show, the LTV-method as well as the Swedish covered bond market is accessible at the website of ASCB (www.ascb.se).

Essential Terms and conditions of a typical Swedish market maker agreement

The market maker has a duty to:

> Help the issuer sell bonds via taps of the benchmark loans in the market;

> Actively support trading of these bonds in the secondary market; and

> Continuously quote indicative rates in the information systems used.

These obligations apply to a limited number of the issuer's loans – the benchmark-loans. Typically 5 to 8 loans of a big issuer have this status with respect to outstanding volume. Using the on-tap issuing technique a loan typically reaches bench-mark status when the outstanding loan amount is SEK 3-5 bn. (At the peak of the life of the bond it typically has a volume of SEK 50 to 70 bn. After that the volume falls due to active repurchase operations by the issuer. With one year to go to maturity a loan is no longer of benchmark status. This paves the way for a controlled redemption of the remaining part of the loan.)

The bid ask spread shall be in line with present market conditions and the trading lots shall typically exceed SEK 500 million.

The obligations of a market maker are conditional upon a number of things of which the following could be mentioned:

> that no change in the economic, financial or political conditions have occurred which in the reasonable opinion of the market maker would create a major obstacle to the fulfilment of the obligations;

> that the bonds, in the reasonable opinion of the market maker, cannot be placed in the primary or secondary market on normal market conditions.

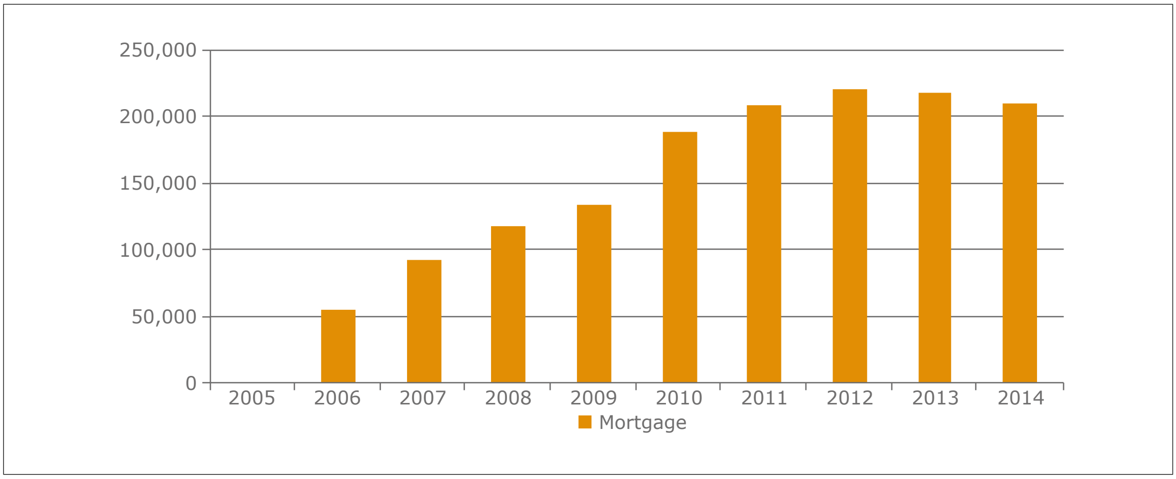
If so, the market marker shall notify the issuer and may withdraw from the duties wholly or in part for a shorter or longer time.

The market maker also has an obligation to trade two futures (2 and 5 year) of the issuer in a similar way as that of the benchmark bonds..

The issuer on his side has an obligation to (under normal market conditions) supply the market maker with a repo facility in the outstanding benchmark bonds. (This facility used to be unlimited. Today, however, the limit is set by the available cover in the cover pool of the issuer.)

With respect to transparency, the issuer shall make public at the end of each week figures on outstanding benchmark loans as of the last day of the previous week.

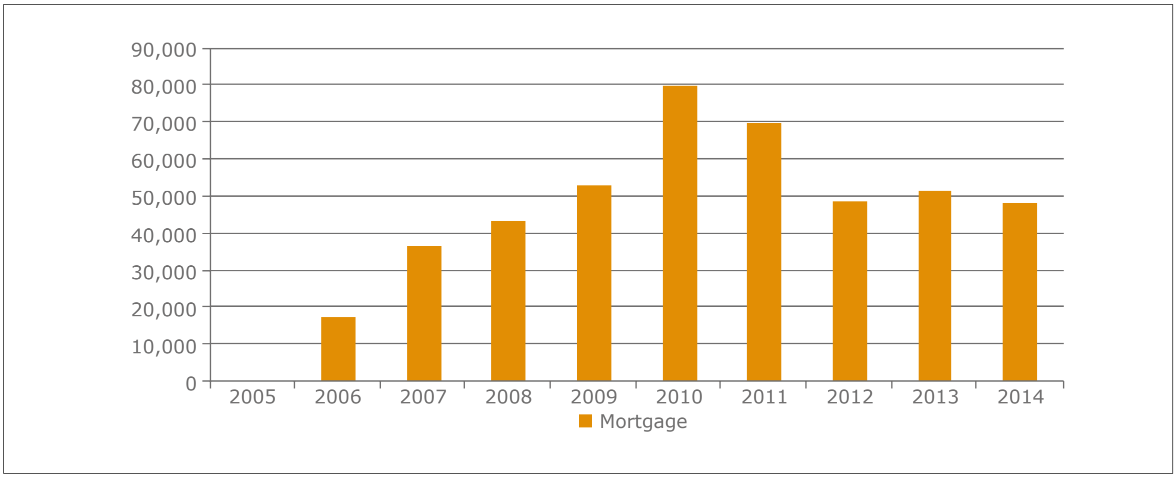
> Figure 2: Covered Bonds Outstanding, 2005-2014, EUR m



Source: EMF-ECBC

Notes: The first covered bonds were issued in 2006 with the application of the Covered Bond s Issuance Act. Prior to 2006 only mortgage bonds were issued in Sweden and as they are not directly comparable to covered bonds they are not included in the figures. In the graph only covered bonds are present.

> Figure 3: Covered Bonds Issuance, 2005-2014, EUR m



Source: EMF-ECBC

Issuers: Stadshypotek, Swedbank Mortgage, Nordea Hypotek, Swedish Covered Bond Corporation (SCBC), SEB, Skandiabanken, Länsförsäkringar Hypotek and Landshypotek. The market is dominated by the first five of them and the majority of their exposure is to domestic residential mortgages, with the remainder consisting of commercial property loans and public sector loans.

ECBC Covered Bond Comparative Database: http://ecbc.eu/framework/47/Swedish_Covered_Bonds.

Covered Bond · Label · : Länsförsäkringar Hypotek AB; Nordea Hypotek cover pool; SEB Cover Pool; Stadshypotek Swedish Pool; Stadshypotek Norwegian Pool; Swedbank Mortgage cover pool; The Swedish Covered Bond Corporation.

3.34.1 SWITZERLAND – SWISS PFANDBRIEFE®

By Robert Horat, Pfandbriefbank schweizerischer Hypothekarinstitute AG

I. FRAMEWORK

The legal framework for the Swiss Pfandbrief system is the Pfandbrief Act ('Pfandbriefgesetz', 'PfG'). It is complemented by the Pfandbrief Ordinance ('Pfandbriefverordnung', 'PfV'), the statutes of the Pfandbrief institutes and the valuation regulations. These have to be authorised by the Swiss Federal Council.

According to the PfG, the issuance of Swiss Pfandbriefe is reserved to two specialised Pfandbrief institutes, namely the 'Pfandbriefzentrale der schweizerischen Kantonalbanken AG' (PZ) and the 'Pfandbriefbank schweizerischer Hypothekarinstitute AG' (PB). These issue Swiss Pfandbriefe to refinance their member banks' Swiss mortgage business. As of article 1 of the PfG the purpose of the Pfandbrief institutes is to enable mortgages for real estate owners at interest rates which are as constant and favourable as possible. The Swiss Pfandbrief® is a registered trademark. The reputation of this brand shall underpin its uniqueness within the world of covered bonds.

The Swiss Pfandbrief system is an indirect one: The Pfandbrief institutes raise money by issuing Swiss Pfandbriefe in order to grant Pfandbrief loans to their member banks. Sourced volume, currency and interest terms must be equal within each series of issuance. To get a loan, each member bank has to pledge first class Swiss mortgages to the Pfandbrief institute as a cover in advance. The Pfandbrief investors have a lien on the granted loans. The investors' lien on the loans as well as the issuers lien on the mortgages in the member banks' cover pool are determined by the Pfandbrief Act.

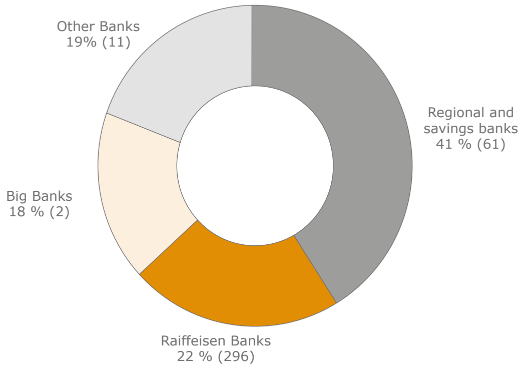
PfG came into effect in 1930. Its 52 articles are well balanced and the PfG had to be modified only marginally in the meantime. The fact that the Swiss Pfandbrief has a special legal basis, provides legal certainty as well as stability and predictability.

Pfandbrief institutes have a strictly limited scope.

II. STRUCTURE OF THE ISSUER

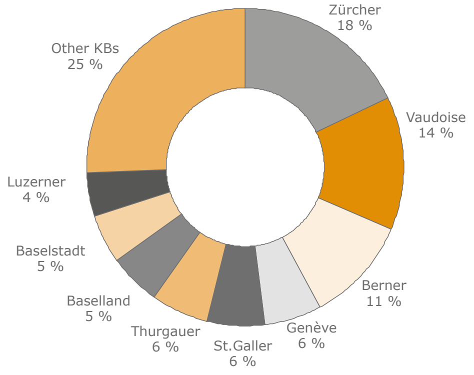
Pfandbriefzentrale operates as the Pfandbrief issuing vehicle of the Swiss cantonal banks and Pfandbriefbank of all other Swiss banks. Both are special institutions with their business scope limited to the issuance of Swiss Pfandbriefe, to granting Pfandbrief loans to their member banks and to investing their share capital and reserves. Both Pfandbrief institutes are supervised by the Swiss financial market authority (FINMA). They are owned by their member banks. The chart below shows the structure of the shareholders:

> FIGURE 1: SHAREHOLDERS OF PB



Source: PB as of 31.12.2014

> FIGURE 2: SHAREHOLDERS OF PZ



Source: PZ as of 31.12.2014

The two Pfandbrief institutes are self-help-organizations, or, in other words, the bond issuing departments and cover pool of their member banks outsourced to the Pfandbrief institutes.

PB was founded in 1931 and counts 353 member banks with loans. Any Swiss bank has the right to become a member of PB, provided that it is headquartered in Switzerland and that Swiss mortgages account for at least 60 % of the bank's balance sheet. As of 31 December 2014 the total outstanding Swiss Pfandbriefe of PB amount to CHF 56.1 billion (EUR 46.6 billion).

PZ was also founded in 1931 and has 24 member banks. Only cantonal banks have the right to become members of the PZ (Article 3 PfG). PZ does not have its own staff but has fully outsourced its operations to Zürcher Kantonalbank. As of 31 December 2014 the total outstanding Swiss Pfandbriefe of PZ amount to CHF 38.3 billion (EUR 31.8 billion).

The total volume of all outstanding Swiss Pfandbriefe as of 31 December 2014 amounts to CHF 94.4 billion (EUR 78.4 billion). For years the two Swiss Pfandbrief institutes have been the major bond issuers in Switzerland, even more important than the government. In 2014 they issued Swiss Pfandbriefe amounting to CHF 16 billion (EUR 13.3 billion).

Swiss Pfandbriefe are standardised to a great extent. They are a commodity, denominated only in Swiss francs, with an original time to maturity up to 30 years. The size of an issuance depends either on the demand of the member banks for loans or on the demand of the investors for Swiss Pfandbriefe, whichever is smaller. Whenever possible, existing bonds are reopened.

Generally, Swiss Pfandbriefe are issued as public bonds through a banking syndicate at fixed term fees (the last private placement has been placed in 2011). All of these public issuances are listed on the SIX Swiss Exchange AG. In the segment of the domestic bonds in Swiss Francs public sector (Swiss sovereign, cantons, cities) amount to 36 %, followed by Swiss Pfandbriefe with 28 %, the banking sector with 13 % and other industries with 23 %.

In total about 10 % of all Swiss mortgages are refinanced through Swiss Pfandbriefe (12/2013).

III./IV. COVER ASSETS, VALUATION AND LOAN TO VALUE (LTV) CRITERIA

As a principle, Pfandbrief loans are only granted against a pledge of eligible first class mortgages on Swiss properties.

PB has got an electronic cover pool. Mortgages are pledged to PB by the member banks through entry of a complete 'cover proposal' into the electronic pool register, which all member banks are linked to. The system immediately evaluates the member bank's 'cover proposal', which is then reviewed by one employee and authorized by another. PB valuates the mortgages independently from the member bank. Substantial cover proposals are additionally reviewed by a special cover pool committee.

The PfG defines a general maximum LTV of two thirds (Article 5 PfG). Member banks are obliged to replace impaired, non-performing and other ineligible mortgages. Furthermore, contractual repayments of the mortgage can also reduce the cover value of the asset pool. Therefore, member bank and PB have to supervise overcollateralisation daily. If total cover value is below the overcollateralisation limit, latest by close of business new eligible mortgages have to be pledged by the member bank.

The 'Pfandbriefbank pool' consists of approx. 147'000 mortgages all over Switzerland, which provides a good diversification. 99 % of the properties are residential and 1 % commercial.

If macro economic conditions change materially, FINMA may request a new valuation of the real estate properties (Article 32 PfG).

V. ASSET – LIABILITY MANAGEMENT

Cover principles

The PfG stipulates that the principal amount and interest payments of outstanding Swiss Pfandbriefe be at all times covered by an equivalent amount of Pfandbrief loans to the member banks (Article 14 PfG). The loans granted by Pfandbrief institutes to their member banks must be collateralised by liens on eligible real estate property (Article 19 PfG). If the interest proceeds total of the pledged mortgages of a member bank is smaller than its total Pfandbrief loan interest, the asset cover pool must be increased (Article 20 PfG).

Overcollateralisation

Additionally to eligibility and valuation principles (LTV legally at maximum 2/3, for PB the average LTV is less than 50 %), the cover value of the cover register assets have to exceed the Pfandbrief loans given to member banks by at least 8 % for PB und by 15 % for PZ. The higher overcollaterisation of PZ compensates for the fact that PZ does not have an electronic cover pool register.

Additional Limits

Swiss Pfandbriefe are issued in individual series which must match the repayment profile of the Pfandbrief loans to member banks, eliminating interest rate and funding risks. Currency risk does not exist as both the loans to member banks and the Pfandbriefe are issued in Swiss Francs. Therefore there is no need for derivatives to hedge market risks. Liquidity concentration risk is limited by individual limits for each member bank. The investment policy for free assets limits credit and market risks on counterparty and portfolio level.

Growth of the Pfandbrief institutes is limited as the required capital must exceed 2 % of the total Pfandbrief issuance volume of the respective institute (Article 10 PfG).

VI. TRANSPARENCY

Although Switzerland does not participate in the 'Covered Bond Label' self-certification programme, PB publishes the 'Pfandbriefbank Pool' report (incl. member bank rating distribution, region, property type, property type by cover value size, loan to value) semi-annually on its home page (www.pfandbriefbank.ch).

VII. COVER POOL MONITOR AND BANKING SUPERVISION

PB valuates the cover pool independently of the member bank (which grants the mortgage to the house owner) and monitors eligibility and overcollateralisation of the cover pool daily. Mortgages are back-tested by means of a hedonic valuation model. Additionally, a special cover pool committee reviews substantial mortgages and visits major properties.

The Swiss Federal Council approves by-laws and valuation regulations and nominates one member of the board of directors.

Swiss Pfandbrief institutes as well as their member banks are supervised by FINMA and audited by external audit firms.

In addition, Moody's rates all Swiss Pfandbriefe with Triple A, investors analyse the annual reports of the Pfandbrief institutes, analysts of CS, UBS and ZKB publish research reports and last but not least capital market values Swiss Pfandbriefe on a daily basis.

VIII. SEGREGATION OF COVER ASSETS AND BANKRUPTCY REMOTENESS

In the event of a member bank's insolvency, the Pfandbrief institute has a priority claim on the registered collateral (Article 23 PfG). The insolvency of a member bank does not directly trigger the acceleration of outstanding Pfandbriefe. In this respect, the Pfandbrief institute functions as a buffer between the investors and the member banks. The Pfandbrief institutes have own funds at their disposal and maintain an unencumbered SNB-/repo-eligible bond portfolio within their free assets.

Should there be justified concern that a member bank is over indebted, has serious liquidity problems or that the bank not longer fulfils the capital adequacy provisions (Article 25 Banking Act – BankG), FINMA can order

a) protective measures pursuant to Article 26 BankG. However, it is to mention that FINMA can order deferment of payments or payment extension, except for mortgage-secured receivables of the Pfandbrief institutes (Article 26 h BankG).

b) restructuring procedures pursuant to Article 28 – 32 BankG: If it appears likely that the member bank can continue to provide individual banking services (regardless of the continued existence of the bank concerned) or can recover, FINMA can issue the necessary provisions and restructuring orders (Article 28 BankG). The approval of the bank's General Assembly is not necessary (Article 31 BankG).

c) the member bank's liquidation due to bankruptcy pursuant to BankG art. 33 – 37 g: Should there be no prospect of restructuring or if a restructuring were to fail, FINMA will have to revoke the bank's licence, order its liquidation and make this public (Article 33 BankG).

The Banking Insolvency Ordinance (BIV) defines restructuring proceedings and bankruptcy proceedings under Article 28 – 37 g BankG in detail. This includes that FINMA may draw up a separate schedule of claims for claims secured by a registered pledge of the Pfandbrief institutes, if systemic risks can only be restricted by doing so (Article 27 BIV). FINMA can also order the delivery of the cover assets and then act as fiduciary (Article 40 PfG) or arrange for a sale of the cover assets to other banks. In such a case Pfandbriefe would accelerate and Pfandbrief investors would rank pari passu among themselves on the proceeds of the asset sales (Article 29 PfG).

IX. RISK-WEIGHTING & COMPLIANCE WITH INTERNATIONAL LEGISLATION

Basel III capital

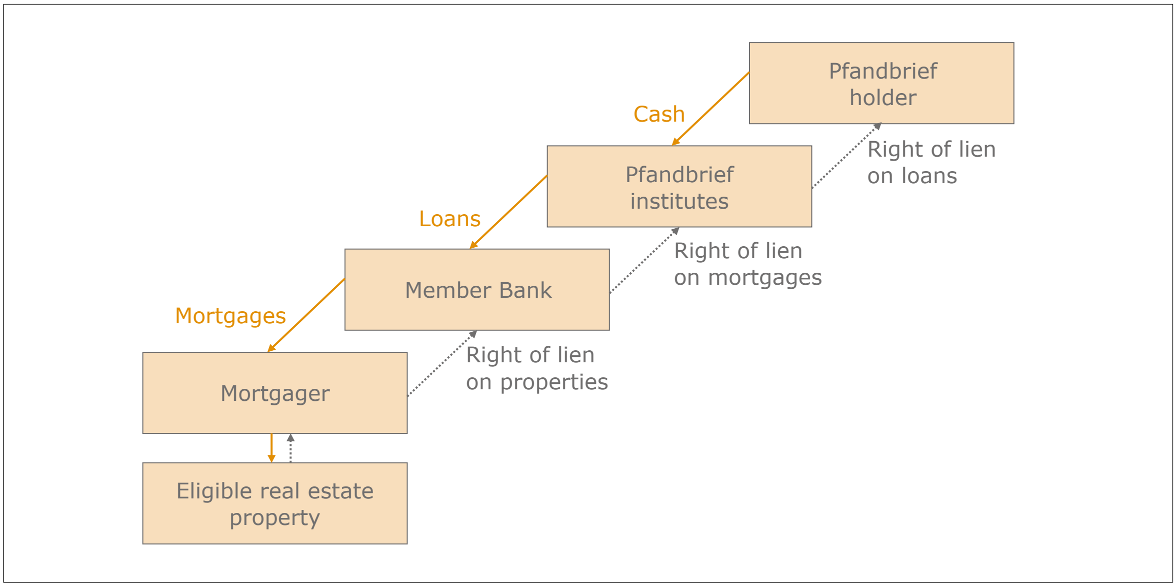
Switzerland implements Basel III capital requirements by means of the 'Banking Act' and the 'Swiss Capital Adequacy Ordinance' (CAO) into national law. The CAO has two approaches to measure credit risks in banking books: The BIS standard approach and the internal ratings-based approach. Under the BIS standard approach Swiss Pfandbriefe have a 20 % risk weighting.

Basel III liquidity

Switzerland implements Basel III liquidity requirements by means of the 'Banking Act' and the 'Liquidity Ordinance' (LiqO) into national law. Swiss Pfandbriefe are on the SNB GC basket list and are therefore eligible for SNB repo transactions. As Swiss Pfandbriefe fulfil the criteria for high-quality liquid assets (HQLA) they are not affected by the redefinition of collateral eligible for SNB repos effective 1 January 2015.

The Bank for International Settlements regulary assesses the consistency of implementation of Basel III standards. Switzerland passed with an overall grade of "C" ("C" = compliant, source Basel Committee on Banking Supervision, June 2013, Regulatory Consistency Assessment Programme (RECAP), Assessment of Basel III regulations – Switzerland).

> FIGURE 3: THE SWISS PFANDBRIEF MODEL


Pfandbrief holder
Cash
Pfandbrief institutes
Right of lien on loans
Loans
Member Bank
Right of lien on mortgages
Mortgages
Mortgager
Right of lien on properties
Eligible real estate property

Source: Credit Suisse AG

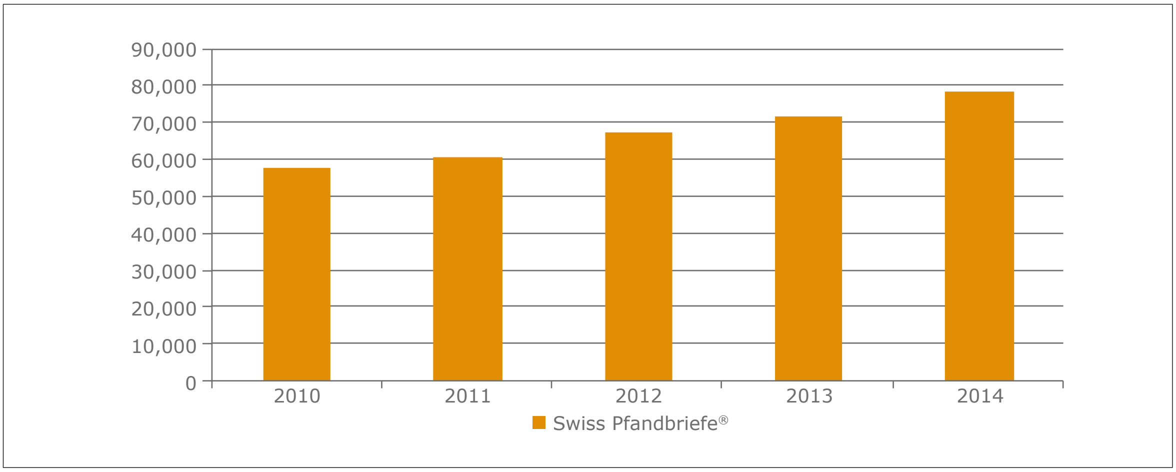
X. INVESTORS BENEFITS

An investor in Swiss Pfandbriefe benefits from

- the special institute principle with strictly limited scope.
- Swiss legislation applicable for all contracts within the Swiss Pfandbrief collateral chain.
- the cover pool, which only includes eligible Swiss franc mortgages on Swiss real estate properties.
- the fourfold security which is 1) the creditworthiness of the Pfandbrief institute, 2) the creditworthiness of the member bank, 3) the creditworthiness of the proprietor of the property and 4) the market value of the real estate property itself.
- in the case of PB: The value of the real estate property is independently determined by PB and not by the member bank.
- in the case of PZ: Explicit state guarantee for most of its member banks[1].
- the fact that since the establishment of the PfG in 1930 neither an investor nor a Pfandbrief institute have ever suffered a loss.

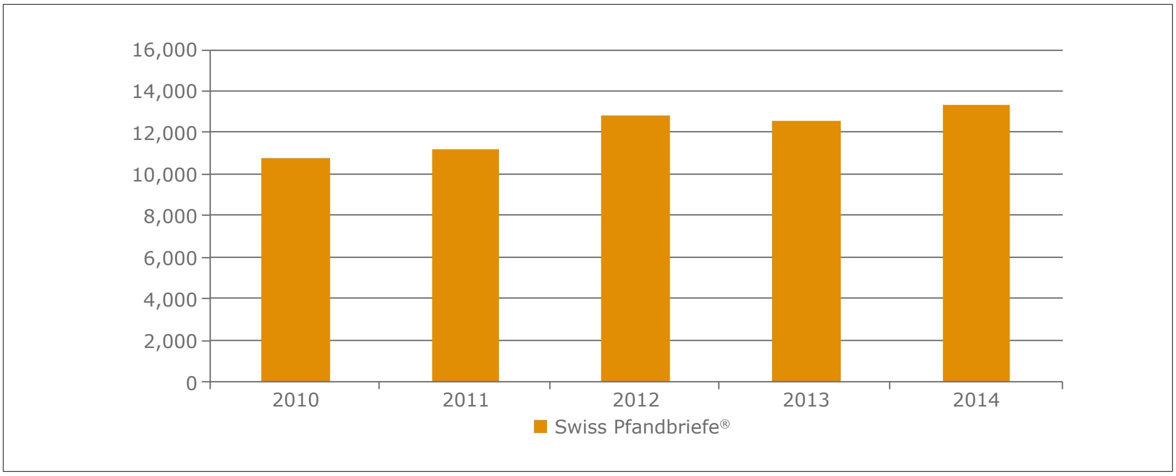
[1] Three of PZ's member banks do not benefit from a cantonal guarantee or have a limited guarantee, namely Banque Cantonale de Genève AG (limited guarantee until 2016), Banque Cantonale Vaudoise AG (no guarantee) and Berner Kantonalbank (no guarantee).

> Figure 4: Swiss Pfandbriefe Outstanding, 2010-2014, EUR m



Source: EMF-ECBC

> Figure 5: Swiss Pfandbriefe Issuance, 2010-2014, EUR m



Source: EMF-ECBC

Issuers: Pfandbriefbank schweizerischer Hypothekarinstitute AG (PB) and Pfandbriefzentrale der schweizerischen Kantonalbanken AG (PZ).

ECBC Covered Bond Comparative Database: http://www.ecbc.eu/framework/82/Swiss_Pfandbriefe.

3.34.2 SWITZERLAND – STRUCTURED COVERED BONDS

By Michael McCormick, Credit Suisse

Credit Suisse and UBS have established structured covered bond programmes in order to access covered bond funding outside of the Swiss Franc market. These programmes are not subject to the Swiss covered bond act, and instead rely on contractual agreements to achieve a dual recourse covered bond structure. In line with legislative Swiss Pfandbriefe, both programmes are backed by prime Swiss domestic residential mortgage collateral.

I. FRAMEWORK

Both programmes use Swiss and English law contractual provisions to implement structural features that are standard in the covered bond market, including direct recourse to the issuer, a privileged claim on a bankruptcy remote cover pool, periodic asset coverage tests, and stringent eligibility criteria for the cover pool assets. These programmes have also adopted very similar structures, with some minor differences as highlighted below.

In line with the guarantor Special Purpose Vehicle (SPV) model used in the United Kingdom and the Netherlands (among other jurisdictions), the issuers have established Swiss-based special purpose companies to guarantee their payment obligations for the benefit of the covered bondholders. These guarantor entities hold security over the programmes' respective cover pools and may use the cover pool assets to make payments on the covered bonds should the issuer fail to do so. The guarantee comes into operation following an issuer event of default, subject to certain conditions. All covered bonds issued under the respective programme rank pari passu with each other and benefit equally from the guarantee.

The guarantors are ring-fenced, bankruptcy-remote entities designed to be unaffected by the insolvency of the group to which they are consolidated (both guarantors are majority-owned by their respective issuer).

II. STRUCTURE OF THE ISSUER

Both issuers today are large financial institutions regulated by the Swiss banking regulator, Swiss Financial Market Supervisory Authority (FINMA).

The covered bonds issued by Credit Suisse and UBS are direct, unsubordinated, unsecured and unconditional obligations benefiting from a guarantee given by their respective guarantor vehicles. Before an issuer event of default, the issuers must make all payments of interest and principal due on the covered bonds.

III. COVER ASSETS

In both programmes, the collateral consists of Swiss mortgage loans to private individuals and the related mortgage certificates securing such mortgage loans.

Substitution assets can be included in the cover pool. Their aggregate value is limited to a maximum of 15% of the cover pool and may consist of cash and high quality investments such as bank deposits, domestic pfandbriefe and highly government debt.

IV. VALUATION AND LTV CRITERIA

The eligibility criteria for initial inclusion in Credit Suisse's cover pool limits mortgages to those with loan-to-value (LTV) of less than or equal to 100%, while the UBS programme limits eligible mortgages to those with LTV of less than or equal to 80%.

Certain provisions within the programmes' asset coverage test (ACT) implement additional LTV limits by capping the value of each mortgage loan at a specified current LTV, thereby ensuring that the value given to mortgage loan is prudently measured when comparing assets to liabilities. This limit is 70% LTV in the Credit Suisse programme and 80% in the UBS programme.

For both programmes, the mortgages' LTV is regularly calculated using current market values. Credit Suisse undertakes an appraisal of the market value of a relevant property for new and existing customers upon an initial application for a mortgage loan and periodically thereafter (not less than every 15 years or based on relevant new information and/or obvious changes). Such appraisal is undertaken for each mortgage loan application by a hedonic valuation model (the IAZI) or internal appraisers or authorised external appraisers, using the construction value method or the capitalised earnings model. UBS conducts an estimate of the collateral value for all residential mortgages based on the Wuest & Partner valuation model, which is also a hedonic regression model. If other valuation methods are available, UBS takes these into consideration and generally uses the lowest of the estimated values as its assessed market value. This resultant value is intended to provide a realistic valuation applicable for a twelve month period and is subject to annual review.

V. ASSET – LIABILITY MANAGEMEMT

The ACT drives asset coverage requirements in both programmes and is run on a monthly basis. In addition to the LTV limitations described above, a second part of the ACT haircuts the full balance of the mortgages using an asset percentage (AP). The AP is derived from periodic rating agency feedback and sized to maintain a triple-A rating. The value given to the mortgage assets under the ACT is the lower of (i) the result when applying the LTV limits described above or (ii) the value of the mortgage assets multiplied by the AP. In addition, credit is given to cash and substitute assets while further deductions are made for loans in arrears, borrower set-off risk and potential negative carry.

Both programmes include maximum APs under the programme in order to commit their pogrammes to a minimum overcollateralisation. These are 85% and 90% for Credit Suisse and UBS, respectively.

Both covered bond programmes benefit from a number of additional safeguards:

> In practice, exposure to interest rate and currency risks are mitigated by use of derivatives;

> Liquidity risk is mitigated by the requirements to establish reserve funds, maintenance of pre-maturity liquidity for hard bullet covered bonds and the inclusion of 12-month extension periods for soft bullet covered bonds;

> Cash flow adequacy is maintained by periodic interest coverage tests;

> Commingling risk is mitigated by the requirement of all collections arising from the cover assets to be swept into guarantor accounts after loss of specified ratings;

> Minimum rating requirements are in place for the various third parties that support the transaction, including the swap counterparties and account banks.

> There are also independent audits of the calculations undertaken on a regular basis by an asset monitor;

Following the default of the issuer, an amortisation test is run instead of the ACT. The amortisation test mitigates time subordination between the covered bonds series and will be failed if the aggregate loan amount falls below the outstanding balance of all the covered bonds. Upon failure of the test, all bonds accelerate against the guarantor.

VI. TRANSPARENCY

Both issuers have committed to publishing monthly investor reports on a timely basis. These reports provide various information relevant to investors including:

> the monthly calculations of the ACT and the interest coverage test;

> details of outstanding covered bonds and list of parties involved in the transaction;

> the current balance of programme accounts;

- a mortgage portfolio summary disclosing total balances, average loan balance, number of properties, WA remaining terms and WA LTVs;
- tables showing number properties and mortgages by remaining term, current loan to value, total balance, interest rate type, property region, property type, and arrears.

VII. COVER POOL MONITOR AND BANKING SUPERVISION

The issuers are regulated Swiss financial institutions, which are subject to regulation and supervision by FINMA. The results of investor reporting are checked and verified by an independent asset monitor who advises the trustee upon their breach. The cover pools themselves are audited by independent professional auditors at regular intervals.

In addition, rating agencies regularly monitor the programme and re-affirm the ratings on a regular basis.

VIII. SEGREGATION OF COVER ASSETS AND BANKRUPTCY REMOTENESS OF COVERED BONDS

Upon transfer for security purposes of the mortgage loans and the related mortgage certificates, each of the guarantors (Credit Suisse Hypotheken AG and UBS Hypotheken AG) becomes the legal holder of the mortgage loans as well as the legal owner of the mortgage certificates.

Upon the insolvency of the issuer, the mortgage loans and the related mortgage certificates would not form part of the issuer’s estate. Accordingly, the asset cover pool may be managed and enforced by the guarantors independently from the corporate insolvency proceedings of Credit Suisse or UBS.

There are a number of trigger events for default, the first being an issuer event of default. This can occur in a number of situations including the following:

- Failure to pay any interest or principal amount when due;
- Bankruptcy proceedings being ordered by a court or authority against the issuer;
- Failure to rectify any breach of the asset coverage or interest coverage test.

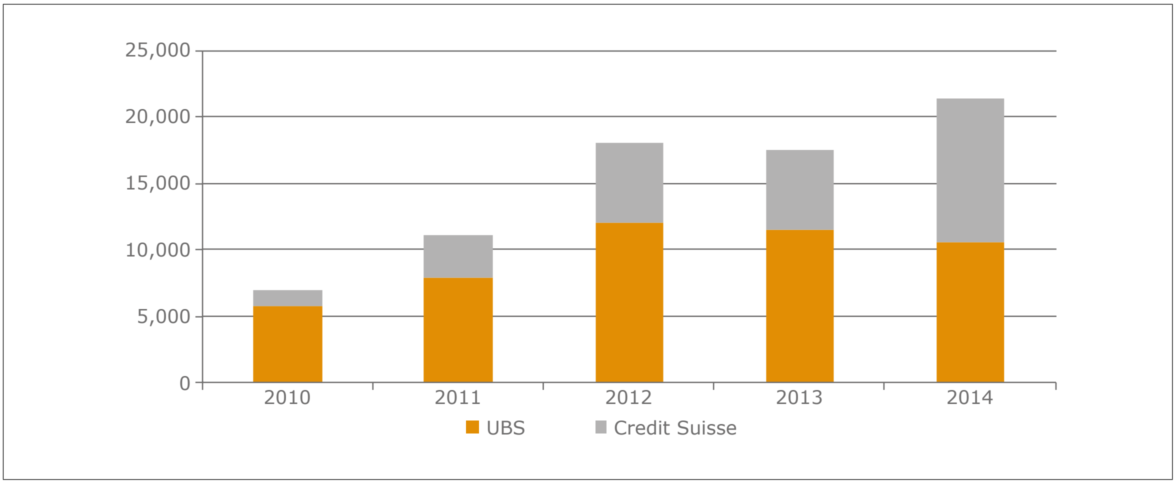
An issuer event of default would not accelerate payments to covered bondholders, but would allow the trustee to activate the guarantee.

The second event of default is the guarantor event of default. This would arise after an issuer event of default if the guarantor failed to make any payments when due, failure of the amortisation test or bankruptcy of the guarantor. A guarantor event of default would cause the acceleration of payments to covered bondholders and their early redemption at the amount relevant to that particular covered bonds series.

IX. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

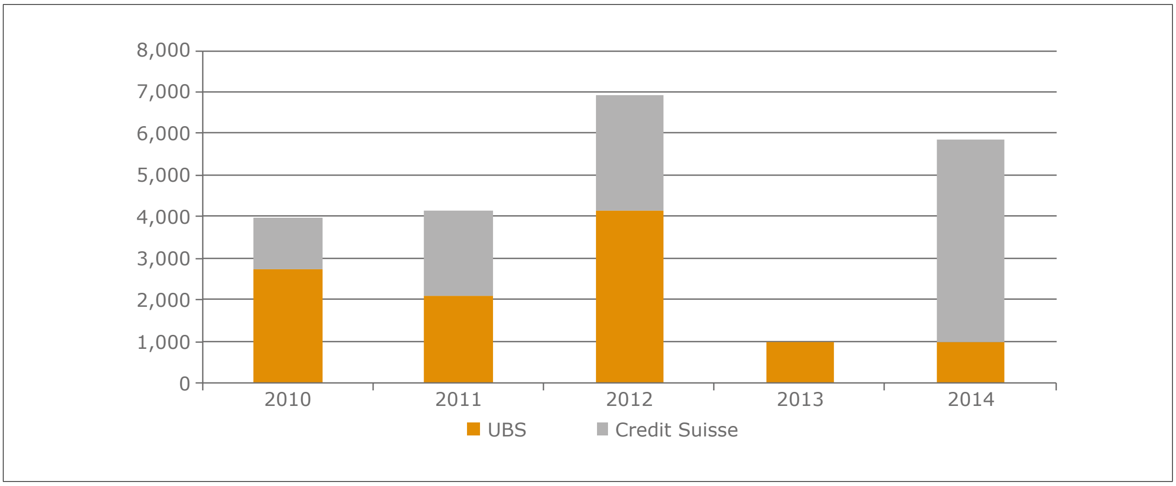
Swiss general-law based covered bonds have a 20% risk-weighting in accordance with the Capital Requirements Regulation (CRR). They fall under Liquidity Category III (structured covered bonds) of the ECB eligible assets criteria.

> Figure 1: Covered Bonds Outstanding 2010-2014, EUR m



Source: EMF-ECBC

> Figure 2: Covered Bonds Issuance, 2010-2014, EUR m



Source: EMF-ECBC

Issuers: Credit Suisse AG and UBS AG.

ECBC Covered Bond Comparative Database: http://www.ecbc.eu/framework/92/Credit_Suisse_CB and http://www.ecbc.eu/framework/78/UBS_CB.

3.35 TURKEY

By Özlem Gökçeimam and Serdar Sarı, Garanti Bank

I. FRAMEWORK

Turkish mortgage-covered bonds are branded as "*İpotek Teminatlı Menkul Kıymet ("İTMK")*" and "Mortgage Covered Bond ("MCB")" in Turkish and English respectively and are trademarked by the legislation.

The primary legislation with respect to the İTMKs is the Capital Markets Law ("CML") and the secondary legislation is the Communıqué on Covered Bonds[1] ("Communiqué") which was published by the Capital Markets Board ("CMB") on 21 January 2014 (as amended from time to time). The Communiqué regulates the MCBs as well as other asset-backed covered bonds; however, this chapter will focus exclusively on MCBs.

Together with its predecessors, the Communiqué is part of a series of legislation following the enactment of "The Housing Finance Law (No: 5582)" on 6 March 2007, which aims to establish a healthy and functioning housing finance system in Turkey.

II. STRUCTURE OF THE ISSUER

İTMKs are capital market instruments qualified as debt instruments, issued within the scope of the issuer's general liability and collateralised by cover assets.

İTMKs may be issued by housing finance institutions (HFIs) and mortgage finance institutions (MFIs). While MFIs are joint stock companies defined in Article 60 of the CML (which entities are joint stock companies, established for the purpose of acquiring and transferring assets with qualifications designated by the CMB, managing such assets or taking such assets as collateral and conducting other activities approved by the CMB within the scope of housing finance and asset finance), HFIs are banks, financial leasing companies and finance companies authorised by the Banking Regulatory and Supervision Agency ("BRSA") to perform housing finance activities.

The issuers are required to obtain CMB approval for the issuance certificate which provides an annual blanket limit and the tranche issuance certificate before each issuance. For the public offerings in Turkey, the prospectus has to be CMB approved as well.

III. COVER ASSETS

An issuer of MCBs is required by the Communiqué to maintain a cover pool for the benefit of such MCBs, which must be in compliance with, inter alia, quantitative statutory tests and the eligibility criteria of the Communiqué. Pursuant to the Communiqué, a cover pool may be created with the following assets:

> receivables of banks and finance companies, resulting from house financing as defined in Article 57 of the CML, which have been secured by establishing a mortgage at the relevant registry;

> commercial loans and receivables of the banks and financial leasing companies and finance companies, which have been secured by establishing mortgage at the relevant registry or, if approved by the CMB; otherwise,

> substitute assets, which include cash (including cash generated from cover assets), Turkish government bonds issued for domestic and foreign investors, securities issued or secured by the central government or the central banks of OECD member states, among some others, and

> derivative instruments fulfilling the conditions of the Communiqué. The Communiqué caps the ratio of the net present value of commercial loans/receivables and the substitute assets separately at 15% of the total net present value of the cover assets.

[1] http://www.cmb.gov.tr/apps/teblig/index.aspx?lang=E&ps=N&submenuheader=-1.

In Turkey, almost all mortgage loans are fixed rate loans and, as a result of a change of law in 2009 requiring loans to Turkish citizens to be denominated in Turkish Lira, all are denominated in Turkish Lira other than a very small number of mortgage loans made to foreign citizens with residences in Turkey. Payments on mortgages are almost always monthly and generally are effected by having the lending bank withdraw funds from a bank account held by the borrower with the lending bank.

The maximum maturity for residential mortgage loans in Turkey is typically 240 months (with only one institution providing loans up to 360 months, while some major banks have a maximum maturity of 120 months). As of 31 December 2014, more than 80% of the residential mortgage loans in Turkey had a remaining maturity shorter than 120 months according to the Central Bank.

Finally, as a matter of Turkish law, borrowers of mortgage loans are required to maintain earthquake insurance for the related real property, subject to a maximum claim of TL 150,000.

The Communiqué sets out the specific requirements that derivative instruments need to satisfy in order for such derivative instruments to be recognised as part of the cover pool. In general:

> the derivative instrument must be traded on exchanges or the derivative counterparty needs to be a bank or financial institution (multi-lateral development agencies also qualify);

> the derivative counterparty needs to have an investment grade long-term international rating (which is tested at the time of entry into of the derivative instrument);

> the derivative instrument cannot be unilaterally terminated by the derivative counterparty even in the event of the bankruptcy of the issuer; and

> the derivative instrument must contain fair price terms and reliable and verifiable valuation methods.

IV. VALUATION AND LTV CRITERIA

The immovable properties securing the mortgage loans must be located in Turkey and the market price of the immovable property is required to have been determined by an independent appraisal company that is listed by the BRSA or the CMB, at the time of utilisation of the mortgage loan.

Typically, the appraisers (a) visit the relevant Land Registry Office, municipality and for on-site measurements the real property to be mortgaged, (b) conduct research regarding reference values.

With respect to loan to value requirements, the portions of the residential mortgage loans and commercial mortgage loans exceeding respectively 75% and 50% of the value of the real estate securing them shall not be taken into consideration in the calculation of the cover matching principles, which are discussed in detail in the following section.

The Communiqué requires the issuers to monitor the general changes in the property prices securing their mortgage loans and determine the ratio of such change annually at the end of each calendar year based upon a generally accepted index, if available. The best established index in Turkey is the Property Price Index (Konut Fiyat Endeksi) (the "KFE") released by the Central Bank on a monthly basis. The calculation of the KFE is based upon the price data of all the properties sold in Turkey irrespective of the construction year of the properties. The price data is obtained from valuation reports prepared for the purpose of evaluating mortgage loan applications made to 10 Turkish banks. If the issuers identify a decline in the property prices within a specific geographical region or in Turkey in general, then they must decrease the value of the relevant property by applying the property price change ratio and re-calculate whether the cover pool assets comply with the requirements of the Communiqué.

V. ASSET – LIABILITY MANAGEMENT

The cover pool must also comply with certain cover matching principles, which shall be monitored by the issuer at every change relating to the cover assets and, in any case, at least once a month. The matching principles involve:

- **Nominal Value Matching:** The nominal value of the cover assets may not be less than the nominal value of the MCB. While calculating the nominal value for purposes of this test, the balance of the principal amounts of the mortgage loans, the issuance price of the discounted debt instruments, and the nominal value of the premium-debt instruments shall be taken into consideration. Contractual value of the derivative instruments shall not be taken into consideration for the calculation of nominal value matching.
- **Cash flow matching:** The sum of interest, revenues and similar income that are expected to be generated from cover assets within 1 year following the calculation date may not be less than the similar payment obligations expected to arise from total liabilities under the MCBs and derivative instruments if any, during the same period.
- **Net Present Value Matching:** The net present value of the cover assets must at all times be at least 2% more than the net present value of total liabilities under the MCBs and derivative instruments if any. This mandatory excess cover of 2% must be constituted of substitute assets.
- **Stress Tests:** The responsiveness of the net present value matching to the potential changes in interest rates and currency exchange rates shall be measured with monthly stress tests. In order to measure the effect of the changes in interest rates, the yield curves obtained from swap rates shall be slid downward and upward in parallel. Parallel sliding shall be made by increasing or decreasing the TL interest rate applicable for each maturity by 300 basis points and the foreign currency interest rate applicable for each maturity by 150 basis points. In order to measure the effect of changes to the currency exchange rates on the cash flows in foreign currency, the foreign exchange buying rate shall be increased and decreased by 30%.

VI. TRANSPARENCY

According to Article 15 of the CML, information, events and developments which may affect the value and price of capital market instruments or the investment decision of investors shall be disclosed to public by issuers or related parties.

The Public Disclosure Platform (PDP) is an electronic system through which electronically signed notifications required by the capital markets and Borsa Istanbul regulations are publicly disclosed. In addition to Borsa İstanbul companies and ETFs, investment firms, mutual funds, pension funds and foreign funds may submit notifications to PDP. Independent audit companies, on the other hand, send the electronically signed financial statements for which independent audit is required, to the relevant company electronically in order to be announced to the public. However, some information on PDP may be published only in Turkish. Please see http://www.kap.gov.tr/en/about-pdp/general-information.aspx for further information.

In order to ensure that the covered bond holders are informed:

- compliance reports on the cover matching principles and the notifications made by the cover monitor (a third party who monitors the cover pool) are required to be announced on the website of the issuer and on the PDP on the day on which the cover monitor delivers its report or the notification to the issuer;
- an investor report is required to be announced on the website of the issuer and on the PDP within six business days following the end of the quarterly accounting period; and
- the fact that the issuer has not fulfilled its payment liabilities under the MCBs partially or fully is required to be announced on the website of the issuer and on the PDP on the date when such fact is known to the issuer.

If MCBs are issued without any public offering, the above-noted announcements are required to be delivered to the MCB investors online, through the Central Registry Agency, and shall be published in the website of the issuer for access by the MCB investors. Issuer can freely determine the method of such announcements if MCBs are issued abroad.

VII. COVER POOL MONITOR AND BANKING SUPERVISION

Pursuant to the Communiqué, an issuer is required to appoint a cover monitor who will be responsible for monitoring the cover pool and will report to the CMB and the issuer with regard to the cover pool. The cover monitor is appointed by the issuer and must possess the expertise and experience necessary to fulfil all of its statutory duties. The company that conducts the independent audit on the financial statements of an issuer may not be designated as a cover monitor. The cover monitor is to be appointed through a cover monitor agreement, a copy of which is to be sent to the CMB within three business days of its execution. The cover monitor can only be removed from its duties by the issuer based upon just grounds to be submitted to the CMB in writing and by obtaining the consent of the CMB

Cover monitor should, among others:

- monitor formation of the cover pool with eligible assets;
- monitor cover pool's compliance with cover matching principles and accuracy of the stress test measurements;
- in case the cover register is kept in electronic form, inspect the adequacy of such system and submit a report including the results of this inspection to the issuer, together with a copy to the Board;
- examine the accuracy of the entries made regarding addition, removal or replacement of cover assets by reviewing the underlying loan documentation and other information and documents, as it may deem necessary;
- in the event of a cover matching principle violation or a default by the issuer, inspect whether measures in connection therewith set forth under the Communique is followed;
- prepare a report at least semi-annually (at least quarterly in case of issuances offered to public in Turkey) indicating its findings regarding compliance with cover matching principles and entries made regarding removal or replacement of cover assets and, if applicable measures to be taken following violation of cover matching principles or default.

The cover monitor is required to report any inconsistencies in the cover register or failures in matching principles to the issuer.

The cover monitor is also authorised to conduct a discretionary review of the cover assets, including substitute assets as well as the derivative instruments in place.

VIII. SEGREGATION OF COVER ASSETS AND BANKRUPTCY REMOTENESS OF COVERED BONDS

A cover register held by the issuer permits the identification and segregation of the cover assets. The collateral backing the MCBs is to be registered in book and/or in electronic form.

Until the MCBs are completely redeemed, even if the management or the supervision of the issuer is transferred to public institutions, cover assets cannot be disposed of for any purpose other than securing MCBs, pledged, or designated as collateral, attached by third parties, including for the collection of taxes or other public receivables, or subject to injunctive decisions of courts or included in the bankruptcy estate of the issuer.

In the event that: (a) the management and supervision of an issuer is transferred to public institutions, (b) the operating license of an issuer is cancelled or (c) an issuer is bankrupt, the CMB may appoint another bank or a mortgage finance institution (in both case, satisfying the requirements for issuers of covered bonds), the cover monitor, another independent audit company or an expert third party institution approved by the CMB to act as an administrator. This administrator would not be assuming the liabilities arising from the cover pool but would manage the cover pool and seek to fulfil the liabilities arising from the cover pool from the income generated from the cover pool.

The administrator may actively manage the cover pool to seek to ensure that the payments under the MCBs and derivative instruments arising from the cover pool are made in a timely manner, and if necessary may sell assets, purchase new assets, utilise loans or conduct repo transactions. The administrator also may (after obtaining the approval of the CMB) transfer the cover pool and the liabilities arising from the cover pool partially or fully to another bank or to a mortgage finance institution satisfying the qualifications required for issuers. In such case, transferee bank or MFI shall become the owner of the cover assets upon such transfer and shall become responsible for the payments arising from total liabilities. The administrator may also suggest the CMB that the MCBs be redeemed early.

Pursuant to the Communiqué, the covered bondholders and hedging counterparties do not need to wait until the completion of the liquidation of the assets in the cover pool for recourse to the other assets of the issuer, with respect to which they will rank pari-passu with unsecured creditors of the issuer.

IX. COMPLIANCE WITH EUROPEAN LEGISLATION

As Turkey is not currently a member of the EU, MCBs are not UCITS-compliant and, therefore, are not compliant with the EU's Capital Requirements Regulation (CRR) and do not qualify for beneficial treatment under the CRR.

The EU opened accession negotiations with Turkey on 3 October 2005. As a candidate for EU membership, Turkey will be obliged to be compliant with EU Directives in case of full membership. Thus, in recent years Turkish authorities were strongly aligning banking regulations to EU standards. The revised Accession Partnership of the EU with the Republic of Turkey from 18 February 2008 foresees that Turkey adapts its regulations to the CRR.

The EU progress report on Turkey, published in October 2013, acknowledges that preparations in the area of financial markets are "advanced" and specifically mentions the newly adopted CML, which aims at "further aligning the legislative framework with the acquis", the whole body of EU law.

ECBC Covered Bond Comparative Database: http://ecbc.eu/framework/50/Turkey.

3.36 UNITED KINGDOM

By Jussi Harju, Barclays and John Millward, HSBC

The UK covered bond market has been established since 2003, initially based on general English law structured finance principles prior to the introduction of a dedicated covered bond regulatory framework by HM Treasury in March 2008 (the Regulated Covered Bonds Regulations 2008 (the "Regulations")). The Regulations overlaid the existing general law and contractual structures, providing the necessary underpinning for compliance under Article 52(4) of Directive 2009/65/EC (the "UCITS Directive")[1] compliance and thereby provided the UK structure with benefits including higher investment limits and higher investment thresholds for insurance companies. All UK regulated covered bonds also comply with the definition of covered bonds set out in Regulation (EU) 575/2013 (Capital Requirements Regulation, or "CRR") thereby qualifying for lower risk-weightings. The Regulations were further amended in November 2011 and November 2012 to further promote the "transparency of UK covered bonds and creating a more prescriptive regulatory framework"[2]. The amendments became effective for regulated programmes from 1 January 2013.

Regulated covered bonds are subject to special public supervision by the Financial Conduct Authority (FCA) as Special Public Supervisor, whose stated aims are to ensure a robust regulated covered bond market in the UK, and to ensure that quality is maintained to preserve investor confidence in the UK regulated covered bond market's reputation. The FCA has a wide range of enforcement powers under the Regulations, including the power to issue directions, de-register issuers or fine persons for any breaches of the requirements under the Regulations.

I. FRAMEWORK

Under the Regulations, in order to attain "regulated" status there are two general sets of requirements the issuers need to comply with – those relating to issuers and those relating to the covered bond programmes. Issuers are permitted (but are not required) to submit their covered bond programmes to the FCA for recognition. Those issuers and covered bonds that meet all of the criteria set out in the Regulations and are approved by the FCA are added to the register of regulated covered bonds maintained by the FCA[3]. The Regulations only apply to those covered bonds which have been admitted to the register.

Most elements of the regulated covered bond structure are governed by contract, with the Regulations providing an overarching legislative and supervisory framework without prescribing the complete design and contractual arrangements for the product. The Regulations do, however, prescribe certain key structural principles and requirements, including the requirements that assets must always remain capable of covering claims attaching to covered bonds at all times, and priority of claims against the cover pool in a winding up scenario. The FCA also has a veto over material amendments to the contracts, broad powers to enforce its provisions and conducts its own rigorous ongoing review of regulated programmes.

II. STRUCTURE OF THE ISSUER

The Regulations require the issuer to be a credit institution authorised in the UK to carry out regulated activities, such as deposit-taking. It must also have a registered office in the UK and meet certain additional criteria set out by the FCA.

[1] Please click on the following link for further information on the UCITS Directive and the Capital Requirements Regulation (CRR): http://ecbc.hypo.org/Content/default.asp?PageID=504#position.

[2] All UK regulated covered bond key documents are available at the following link: http://www.fca.org.uk/firms/systems-reporting/register/use/other-registers/rcb-key-documents.

[3] The register may be found at http://www.fca.org.uk/firms/systems-reporting/register/use/other-registers/rcb-register.

Regulated covered bonds are direct, unconditional obligations of the issuer; however, investors also have a priority claim over a pool of cover assets in the event of the insolvency of or default by the issuer. The Regulations require all cover assets (including any substitution assets) to be segregated from the insolvency estate of the issuer by being sold to a special purpose entity (referred to in the Regulations as the "owner"), which guarantees the issuer's obligations under the bonds and provides security over the cover assets to a security trustee on behalf of the investors. All transactions to date have used a limited liability partnership (LLP) for this purpose, with the transfer effected via equitable assignment. The purchase price paid by the LLP for the cover assets is either cash (funded by an inter-company loan from the issuer) or a partnership interest in the LLP (a "capital interest in kind").

If the guarantee is activated, the LLP will use the cash flows from the cover pool to service the covered bonds. If these cash flows are insufficient, or within a certain timeframe of the legal final maturity of the bonds, the LLP is permitted to sell cover assets, within certain defined parameters and subject to meeting certain tests to ensure equality of treatment of bondholders.

III. COVER ASSETS

The Regulations broadly allow the following asset types:

> Assets which are listed in Article 129 CRR, subject to the following restrictions:

  > Exposures to credit institutions with ratings below Credit Quality Step 1 (AA-) as set out in the CRR are not permitted; and

  > Securitisations are not permitted.

> Certain assets which are not permitted under the CRR – namely loans to registered social landlords and loans to public-private partnerships (and loans to providers of finance to such companies, and subject in each case to certain restrictions).

> Liquid or "substitution" assets up to the prescribed limit (10% in most cases to date).

Issuers are required to designate programmes as either "single asset type" or "mixed asset type". Mixed asset type programmes are allowed to include any of the assets set out above, whereas single asset type programmes would be required to select either residential mortgages, commercial mortgages, or public sector loans (including social housing and PPP loans, which are not CRR-eligible), in each case as defined in the CRR.

The Regulations include a narrow definition of liquid or "substitution" assets, which are defined as UK government bonds (or other government bonds which comply with the requirements set out in Article 129(1)(a)) or (b) CRR or deposits in GBP or another specified currency held with the issuer or with a credit institution which comply with the requirements set out in Article 129(1)(c) CRR.

Cover assets must be situated in EEA states, Switzerland, the US, Japan, Canada, Australia, New Zealand, the Channel Islands or the Isle of Man. If an issuer includes non-UK assets in its cover pool, it must get confirmation that the laws of the relevant jurisdiction would not adversely affect the rights of the LLP or the security trustee.

The Regulations require cover assets to be of high quality, and the FCA is permitted to reject any application for regulated status if it believes that the quality of the proposed assets will be detrimental to the interests of investors in regulated covered bonds or the good reputation of the regulated covered bonds sector in the United Kingdom.

In all of the programmes that have been registered to date, the cover pools consist of assets with narrower eligibility criteria than those allowed under the Regulations, and comprise only UK residential mortgages and the substitution assets described above.

IV. VALUATION AND LTV CRITERIA

The properties securing the mortgage loans are valued using UK mortgage market accepted practice. A surveyor is often used, although other methods (such as automated valuation models) are also accepted. Residential property values are indexed to either the Halifax or Nationwide real estate price index, each of which reports quarterly on a region-by-region basis. Price decreases are fully reflected in the revaluation, while in the case of price increases a 15% haircut is applied.

The LTV limit for mortgages varies across the different programmes (see Figure 1), but in all existing programmes it is below the 80% level for residential mortgages required under the CRR and the Regulations. Loans with LTV above this limit may be included in the pool, but the amount of the loan which exceeds the limit is excluded from the Asset Coverage Test (ACT). Loans which are in arrears are either repurchased by the issuer or subject to additional haircuts (see Figure 1).

V. ASSET – LIABILITY MANAGEMENT

For UK regulated programmes, over-collateralisation (OC) levels are determined according to the higher of: (i) the regulatory minimum amount specified in the Regulations of 8% on a nominal basis, (ii) contractual minimum amounts specified in the legal agreements, (iii) requirements imposed by the FCA, and (iv) amounts required to pass the programme’s ACT (in particular as required to support the given rating level from the relevant rating agencies). However, in many programmes, the contractual minimum amounts specified are already in excess of this regulatory minimum requirement, and in any case the OC required by the rating agencies and/or FCA are significantly higher.

A key principle of the Regulations is that they require the cover pool to be capable of covering all claims attaching to the bonds at all times. In addition to the amounts required either under the regulatory minimum or under the contractual requirements, the minimum OC level for any programme is also considered by the FCA on a case-by-case basis, taking into account the quality of the cover assets, risk-mitigation measures (such as swaps and downgrade triggers) and asset-liability mismatches. The FCA has the power to require the issuer to add further assets to its cover pool if it deems the collateral to be insufficient.

The principal contractual requirement under UK structures is the presence of a dynamic ACT which must be carried out on a monthly basis to ensure that minimum OC requirements are satisfied. The ACT requires the discounted value of the cover pool (after applying the haircuts listed below) to be equal to or exceed the principal amount outstanding of covered bonds. The following haircuts are applied:

> The adjusted value of the mortgage pool is calculated by taking the lower of: (i) balance of mortgages up to the indexed LTV limit specified in the programme documents, and (ii) the asset percentage multiplied by the balance of mortgages.[4] Performing mortgages get credit 60-75% while for non-performing mortgages (i.e. >3m in arrears) this is 0-40%, depending on the programme.

> Any cash or substitution assets are also included.

> Additional haircuts are applied to mitigate set-off risk, redraw risk on flexible mortgages (if appropriate), and potential negative carry.

The asset percentage is determined on an on-going basis by the rating agencies and is subject to a maximum as set out in the programme documents (which corresponds to the minimum contractual requirement, Figure 1).

[4] For example: Let us assume a cover pool which contains two loans. Each loan has a principal balance of GBP 80 and is secured by a property worth GBP 100. If the ACT applies an LTV cap of 75% and an asset percentage of 90%, the issuer will get credit for GBP 144 of loans: applying the LTV cap would allow GBP 150 (maximum 75% LTV for each loan); but the asset percentage allows a lower amount (GBP 160 x 90% = GBP 144) and therefore takes precedence.

The issuer is required to rectify any breach of the ACT within a specified timeframe by transferring additional cover assets to the LLP. If the breach is not rectified within the allowed remedy period, the trustee will serve a notice to pay on the LLP (see Section VIII below). The issuer may also become liable to enforcement action by the FCA.

An amortisation test is run on each calculation date after the delivery of a notice to pay (see Section VIII below), which is designed to ensure that the cover pool will be sufficient to make payments under the covered bonds as required under the guarantee. The amortisation test is similar to the ACT, but more simply tests whether the principal balance of mortgages is sufficient to make payments in full on covered bonds, taking into account negative carry. If the test is failed, the covered bonds will accelerate against the LLP.

Most UK covered bond transactions currently in the market have been issued with a soft-bullet maturity. Following the service of a notice to pay, the legal final maturity may be extended, typically by 12 months, in order to allow the realisation of the cover assets. It is important to note that the issuer does not have the option to extend the bond's maturity; failure by the issuer to repay the bond in full on the scheduled maturity date would result in an event of default.

Certain programmes include a hard bullet option, whereby a "pre-maturity test" is designed to ensure that the LLP has sufficient cash available to repay the bonds, in full, on the original maturity date in the event of the issuer's insolvency. If, in a specified period before a maturity date (6-12 months, depending on the issuer and the rating agency), the issuer's ratings fall below certain specified triggers (typically A-1+ / P-1 / F1+), the pre-maturity test requires the LLP to cash-collateralise (either via cash contributions from the issuer or by selling cover pool assets) its potential obligations under the guarantee.

All regulated covered bond programmes include a number of other safeguards. In particular, there are minimum rating requirements for the various third parties that support the transaction, including the swap counterparties and bank account providers, and an independent asset monitor is required to undertake an audit of the cash manager's calculations on a regular basis. Furthermore, if the issuer's short-term ratings are below certain trigger thresholds (most programmes have triggers of A-1+/P-1/F1+), the LLP is required to establish and maintain (from the asset cash flows), a reserve fund which is the higher of (i) the next three months' interest payments on a rolling basis, and (ii) the next following interest payment, together with the relevant amount of senior costs and GBP 600,000 (as required under the UK's Enterprise Act). This amount is retained in the LLP's bank account.

VI. TRANSPARENCY

UK regulated covered bond programmes benefit from extremely detailed investor reporting conventions in comparison to many other jurisdictions. The market has conformed to a relatively high standard of reporting since inception, but in addition the FCA requires detailed reporting to be provided by regulated issuers in its capacity as special public supervisor.

Similarly, transparency is to a large extent driven by the eligibility criteria in the Bank of England (BoE) Sterling market operations, under which (among other things) issuers must publish transaction documentation, provide homogenised transaction summaries and investor reports, and publish loan level data.

FCA reporting requirements, which were updated in December 2011 and became effective in January 2013, are closely aligned with the BoE criteria but also include certain additional items not included in the BoE criteria. Since the introduction of the updated amendments, all regulated issuers comply with both sets of rules.

In addition, seven of the twelve UK regulated covered bond issuers (Abbey National Treasury Services, Clydesdale Bank, Coventry Building Society, Lloyds Bank, Nationwide Building Society, Royal Bank of Scotland and Yorkshire Building Society) have adopted the ECBC label initiative and report in the UK National Transparency Template: https://www.coveredbondlabel.com/issuers/national-information-detail/27/

VII. COVER POOL MONITOR AND BANKING SUPERVISION

An applicant under the Regulations must be a credit institution authorised in the UK to carry out regulated activities, such as deposit-taking. Issuers must satisfy the FCA that their programmes comply with the criteria set out in the Regulations and provide, among other things:

> Details on the quality of cover assets and the ability of the assets on the issuer's balance sheet to satisfy substitution requirements;

> Details concerning the programme structure, such as the cover pool eligibility criteria, the formulae used to calculate compliance with minimum OC requirements, ability to meet payments on a timely basis and ratings triggers;

> Details concerning asset and liability management, audit and controls, risk management and governance framework;

> Details on the proficiency of cash management and servicing functions;

> Detailed analysis on the ability of the assets and the mitigants within the programme structure to address inherent interest rate, currency, asset and liability mismatch and market value risks;

> Arrangements for the replacement of key counterparties; and

> Independent legal and audit opinions on the compliance of the issuer and programme with the Regulations.

The issuer is responsible for monthly cover pool monitoring. The FSA must be notified by the issuer of any breaches of the ACT, and may also require the issuer to provide such additional information about the cover pool as it considers fit. All existing programmes have at least two internationally recognised rating agencies who will also undertake detailed reviews both on a condition precedent to each issuance, and thereafter on at least a quarterly basis as part of ongoing transaction surveillance. The rating agencies may revise the asset percentage as part of these review processes, either due to variations in asset quality or embedded transaction risk factors, or due to periodic rating criteria change.

All programmes since inception have included an independent third party asset monitor within the existing contractual arrangements who are required to perform various functions within the transaction including an annual review of the ACT calculation, and periodic audit procedures to be undertaken with respect to the asset pool.

In November 2011, the Regulations were updated to formally codify the role of an independent "Asset Pool Monitor" which (i) must be eligible to act as an independent auditor (ii) is conveyed with certain powers to inspect books and records associated with the relevant programme, (iii) must conduct a biannual inspection of the issuer's compliance with its duties as set out in the Regulations, and (iv) must report to the FCA on an annual basis (or sooner if the issuer is found to be failing to comply with its duties). These additional requirements became effective on 1st January 2013 and regulated programmes have generally been updated to reflect the amendments.

VIII. SEGREGATION OF COVER ASSETS AND BANKRUPTCY REMOTENESS OF COVERED BONDS

The Regulations require all cover assets (including any substitution assets) to be segregated from the insolvency estate of the issuer by being transferred to a special purpose entity (referred to as the "owner" in the Regulations), which guarantees the issuer's obligations under the bonds. All transactions to date have used an LLP for this purpose.

The Regulations require that the cover assets be recorded on a register maintained by or on behalf of the issuer and the LLP. The register must be available for inspection by the FCA. The issuer is responsible for ensuring that all cover assets meet the relevant eligibility criteria set out in the Regulations and, if applicable, any additional criteria set out in the programme documents.

The LLP becomes obliged to pay the covered bondholders under the guarantee upon delivery by the bond trustee of a notice to pay following the occurrence of an issuer event of default or other trigger event. The events which can trigger a notice to pay typically include:

> Failure by the issuer or any group guarantors to pay any interest or principal on the covered bonds when due;

> Bankruptcy or similar proceedings involving the issuer or any group guarantors;

> Failure to rectify any breach of the asset coverage test (in most cases); and

> Failure to rectify any breach of the pre-maturity test (if applicable).

To the extent that an issuer event of default has occurred, the bond trustee may commence proceedings against the issuer and any group guarantors on an unsecured basis on behalf of the covered bondholders. The delivery of a notice to pay does not however accelerate payments to noteholders, and the LLP will continue to make payments of interest and principal on the covered bonds on their originally scheduled payment dates (provided that an LLP acceleration event (as described below) has not occurred).

LLP acceleration events typically include:

> The LLP fails to pay any interest or principal when due under the guarantee;

> Bankruptcy or similar proceedings are commenced involving the LLP; and

> After delivery of a notice to pay, the LLP breaches the "amortisation test".

The occurrence of an LLP acceleration event causes the acceleration of payments by the LLP to covered bondholders and the redemption of the bonds at the relevant early redemption amount.

The LLP is reliant on the proceeds derived from the cover assets to make payments under the guarantee. Under the Regulations, in a winding up scenario, no claims against the cover assets can rank ahead of the claims of the regulated covered bondholders. If the proceeds from the cover pool are insufficient to meet the obligations to bondholders in full, investors will continue to have an unsecured claim against the issuer (and any group guarantors) for the shortfall.

IX. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

The list of eligible assets under the Regulations is in some respects narrower than that set out in the CRR (particularly for single asset type programmes as described above). To date, all existing regulated covered bonds are contractually restricted to containing only residential mortgage assets (as well as substitution assets up to the prescribed limit), meaning they are CRR compliant and therefore benefit from the same preferential treatment as covered bonds from other EU jurisdictions. However, certain assets which are excluded from the CRR – such as loans to UK housing associations – are technically permitted in the cover pool under the Regulations, and so it is possible that in future programmes could be structured which do not qualify for the preferential risk weightings.

> Figure 1: Overview – Regulated UK covered bond programmes

At the time of writing there are 12 regulated covered bond issuers in the United Kingdom: Abbey National (ABBEY); Barclays Bank Plc (BACR); Bank of Scotland Plc (HBOS); Clydesdale Bank Plc (CLYDES); Co-operative Bank (COOPWH); HSBC Bank (HSBC), Leeds Building Society (LEEDS), Lloyds TSB Bank (LLOYDS), Nationwide Building Society (NWIDE); Royal Bank of Scotland (RBS); Coventry Building Society (COVBS) and Yorkshire Building Society (YBS).[5]

	ABBEY	BACR	CLYDES	COOPWH	COVBS	HBOS	HSBC	LEEDS	LLOYDS	NWIDE	RBS	YBS
Programme volume (bn)	€ 35	€ 35	€ 10	€ 3	€ 7	€ 60	€ 25	€ 7	€ 60	€ 45	€ 25	€ 7.5
LTV cap	75%	75%	75%	75%	75%	60%	75%	75%	75%	75%	75%	75%
House price index	Halifax	Halifax	Nationwide	Halifax	Nationwide	Halifax	Halifax	Halifax	Halifax	Nationwide	Halifax	Avg. of Halifax & Nationwide
Maximum asset percentage	91.0%	94.0%	90.0%	93.5%	90.0%	92.5%	92.5%	93.5%	93.0%	93.0%	90.0%	92.5%
Minimum OC*	10%	6%	11%	7%	11%	8%	8%	7%	8%	8%	11%	8%
Current asset percentage	89.3%	74.4%	79.5%	77.5%	87.0%	80.0%	87.0%	83.0%	88.0%	87.0%	76.1%	83.7%
Current OC (Adj. Loan balance/CB outstanding)	19%	25%	22%	36%	23%	22%	3546%	31%	12%	12%	26%	9%
Credit for loans in arrears (>3 months)	LTV<75: 40% LTV>75: 25%	LTV<75: 40% LTV>75: 25%	LTV<75: 40% LTV>75: 25%	LTV<75: 40% LTV>75: 25%	LTV<75: 40% LTV>75: 25%	No credit	LTV<75: 40% LTV>75: 25%	LTV<75: 40% LTV>75: 25%	LTV<75: 40% LTV>75: 25%	LTV<75: 40% LTV>75: 25%	<3M: 75%, >3M: 40%	LTV<75: 40% LTV>75: 25%
Can issue hard bullets? **	Yes	Yes	Yes	Yes	No	Yes	Yes	No	Yes	Yes	Yes	No
Asset monitor	Deloitte	PWC	E&Y	PWC	E&Y	KPMG	KPMG	Deloitte	PWC	PWC	Deloitte	KPMG

* OC = Over-collateralisation, minimum OC calculated as (1/maximum asset percentage)-1.
** Hard-bullets possible only if pre-maturity test is in place and passed / soft-bullets issued with 12-months extension.

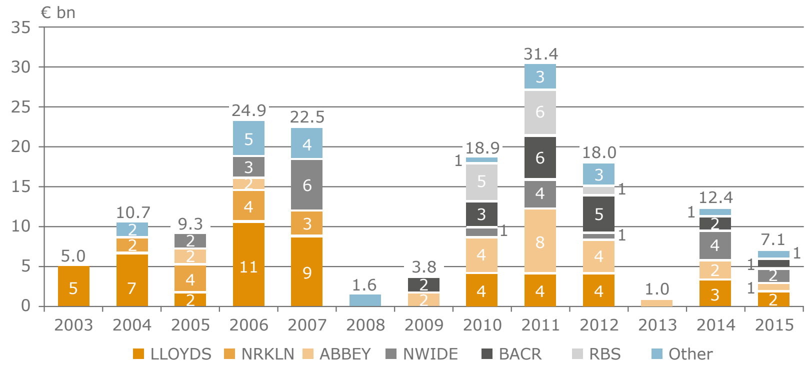
Source: Barclays Research, transaction documents.

[5] http://www.fca.org.uk/firms/systems-reporting/register/use/other-registers/rcb-register.

X. ADDITIONAL INFORMATION

The current outstanding volume of regulated, publicly placed fixed and floating rate benchmark covered bonds and respective taps (benchmark covered bonds hereafter) amounts to EUR 100 bn (equivalent). Issuance in 2014 picked up substantially with EUR 12.4 bn (equivalent) of new covered bonds issued, after only one deal totalling EUR 1 bn issued in 2013. Supply in 2015 has continued reasonable strong with EUR 7.1 bn (equivalent) issued year-to-date (as at end of April). A notable change to previous years has been the increase in GBP issuance: 75% of year-to-date-supply has been denominated in GBP while only two EUR deals have been issued. The GBP supply has been mainly issued in floating rate format though it also included the first fixed-rate GBP benchmark covered bond since 2012. As gross supply in 2014 and year-to-date in 2015 has broadly kept up with redemptions (EUR 13.5 bn (equivalent) and EUR 9.1 bn (equivalent) year-to-date, respectively) the outstanding volume of benchmark UK covered bonds has stopped declining.

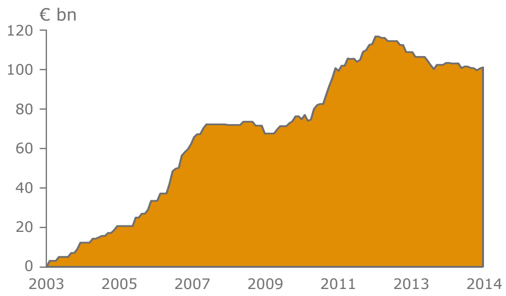
> FIGURE 2: ANNUAL SUPPLY OF UK BENCHMARK COVERED BONDS BY ISSUER (2015 YTD)



Source: Barclays Research

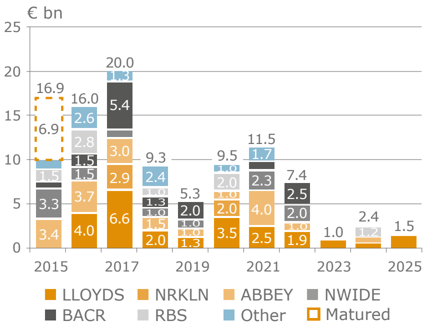
Figures 3 and 4 show the development of total outstanding benchmark UK covered bonds and the annual redemptions per issuer. Figures 5 and 6 show the market share (as measured by covered bonds outstanding) per issuer and the currency distribution for outstanding issuances.

> FIGURE 3: DEVELOPMENT OF OUTSTANDING VOLUME (BENCHMARK COVERED BONDS)



Source: Barclays Research

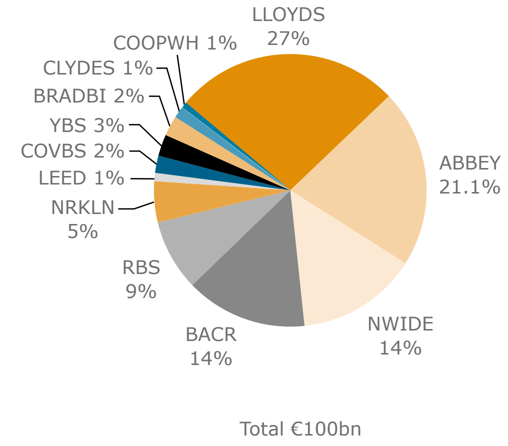
> FIGURE 4: ANNUAL REDEMPTION PER ISSUER (BENCHMARK COVERED BONDS)



Source: Barclays Research

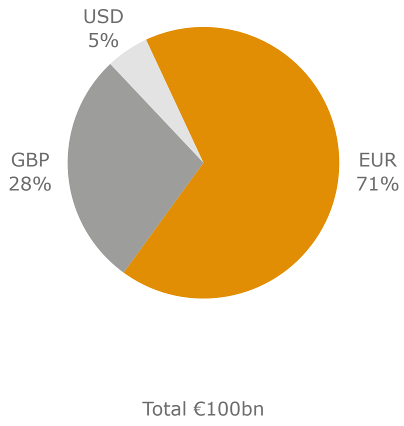
The UK covered bond market still remains predominantly denominated in EUR: at the time of writing 67% of all UK benchmark covered bonds were denominated in EUR. However, the recent increase of GBP issuance has increased the share of GBP covered bonds to 28% (23% last year) while the remaining 5% of the benchmark covered bonds are denominated in USD.

> Figure 5: Market share of outstanding, April 2015 (benchmark issuances)



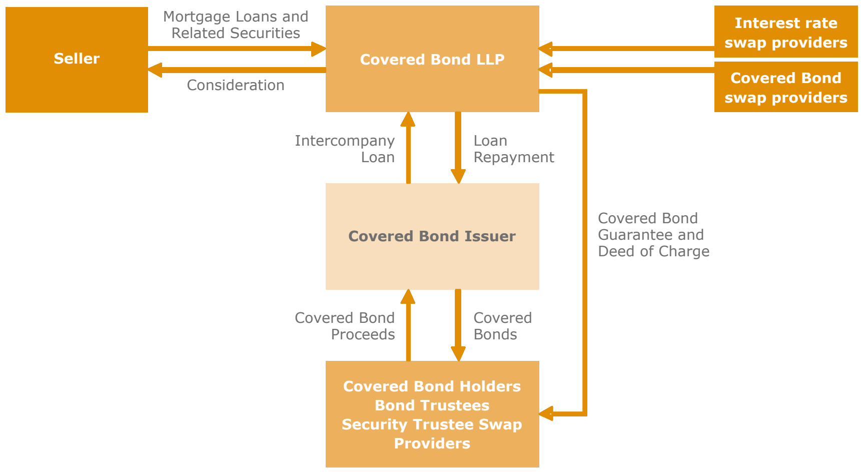
Source: Barclays Research

> Figure 6: Outstanding benchmark issuances by currency, April 2015



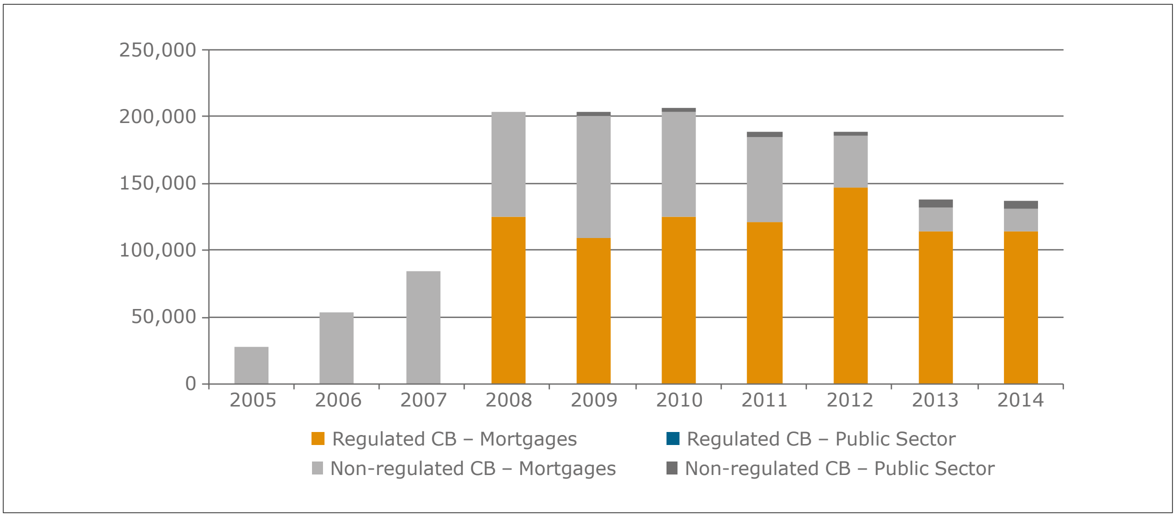
Source: Barclays Research

> Figure 7: Generic UK covered bond programme structure


Seller
Mortgage Loans and Related Securities
Consideration
Covered Bond LLP
Interest rate swap providers
Covered Bond swap providers
Intercompany Loan
Loan Repayment
Covered Bond Issuer
Covered Bond Guarantee and Deed of Charge
Covered Bond Proceeds
Covered Bonds
Covered Bond Holders
Bond Trustees
Security Trustee Swap Providers

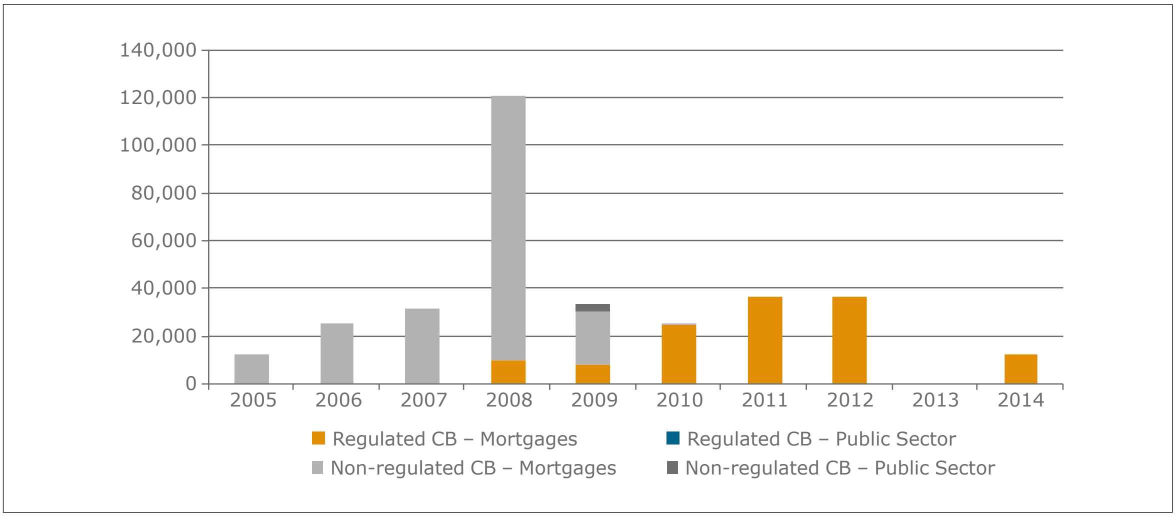
Source: Barclays Research

> Figure 8: Covered Bonds Outstanding, 2005-2014, EUR m



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.

> Figure 9: Covered Bonds Issuance, 2005-2014, EUR m



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.

Issuers: There are 12 regulated issuers each with one regulated mortgage programme (some regulated issuers also have unregulated programmes). For more details, please refer to the FCA's website: http://www.fca.org.uk/firms/systems-reporting/register/use/other-registers/rcb-register.

ECBC Covered Bond Comparative Database: http://ecbc.eu/framework/52/Regulated_Covered_Bonds_-_RCB.

Covered Bond · Label · : Abbey National Treasury Services plc; Clydesdale Bank PLC; Coventry Building Society; Lloyds Bank plc; Nationwide Building Society; Royal Bank of Scotland; Yorkshire Building Society.[6]

[6] https://coveredbondlabel.com/issuers/issuers-directory/.

3.37 UNITED STATES

By Anne Caris, Bank of America Merrill Lynch & Moderator of the ECBC Transparency Task Force

No covered bond legislation has been passed yet in the US despite several attempts in recent years. As such, the two outstanding bonds by Bank of America and Washington Mutual (acquired by JP Morgan) maturing in 2016 and 2017, respectively, are structured covered bonds. The Federal Deposit Insurance Corporation (FDIC) published a Covered Bond Policy Statement back in 2008, which was supplemented by the US Treasury's Best Practices for Residential Covered Bonds. However, the covered bond market never took off on that basis, notably due to possible repudiation by the FDIC.

The latest two legislation attempts, the United States Covered Act in 2011 and the Protecting American Taxpayers and Homeowners (PATH) Act in 2013, aimed to address this concern together with other details but none so far made it through the full legislative process. Within PATH, covered bonds have been discussed as part of the Government Sponsored Enterprises (GSEs) reform being considered as a secondary priority to the latter.

Covered bonds were mentioned twice since then by legislators still suggesting the possibility of US covered bond legislation in the future. First, a speech on 26 June 2014 by Jack Lew, the US Treasury secretary, suggested possible new avenues where covered bonds could have a role to play alongside GSEs. Second, the oversight plan of the Committee on Financial Services for the 114th Congress mentions explicitly the examination of covered bonds.

I. WHAT IS CURRENTLY IN FORCE

The FDIC's Covered Bond Policy Statement

The FDIC Covered Bond Policy Statement, effective from 28 July 2008, aimed to clarify the treatment of covered bonds in a conservatorship or receivership. Under the Federal Deposit Insurance Act (FDIA), any liquidation of collateral of an Insured Depositary Institution (IDI) placed into conservatorship or receivership requires the consent of the FDIC during the initial 45 days or 90 days after its appointment, respectively. Under such conditions, covered bond issuers would need to hold extra liquidity to prevent any default during that time if the FDIC as a conservator or receiver were to fail to make payment or provide access to the pledged collateral. Conscious that this would impair the efficiency of covered bonds, the FDIC decided to grant consent for expedited access to pledged covered bond collateral for covered bonds meeting specific criteria.

Eligible covered bonds must be authorised by the IDI's primary federal regulator and cannot exceed 4% of total liabilities. They consist of non-deposit, recourse debt obligations of an IDI with maturity between one year and 30 years secured by eligible mortgages or AAA-rated mortgage-backed securities secured by eligible mortgages, if no more than 10% of the cover assets. Substitute assets may be included (namely US Treasury and agency bonds) as need be for prudent management of the cover pool. Eligible mortgages are defined as first-lien mortgages on one-to-four family residential properties underwritten at the fully indexed rate, relying on documented income and complying with the existing supervisory origination guidance. Issuers should also disclose LTVs for transparency purposes.

The FDIC consents include the following events: (1) if at any time after appointment the conservator or receiver is in default and remains so after actual delivery of a written request to the FDIC for 10 business days, the covered bond holders can exercise their contractual rights including the liquidation of the cover assets; (2) if the FDIC as a conservator or receiver of an IDI provides a written notice of repudiation of a contract to covered bond holders and the FDIC does not pay the damages due by reason of such repudiation within 10 business days after the effective date of the notice, covered bond holders can exercise their contractual rights including the liquidation of cover assets. The liability of a conservator or receiver in such circumstances shall be limited to the par value of the covered bond issued plus interest accrued following its appointment. The statement also highlights that these consents do not waive, limit or affect the rights or powers of the FDIC.

The US Treasury's Best Practices

The Treasury Best Practices issued in July 2008 supplement the FDIC's covered bond policy statement. Their purpose was to support the growth of a transparent and homogeneous covered bond market in the absence of dedicated US legislation. While targeting high-quality residential mortgages to safeguard market liquidity and stability, the US Treasury did not exclude at the time expansion of the covered bond market to other asset classes. As emphasised by the US Treasury, these best practices do not provide or imply any government guarantee but serve only as a template with the following key features:

> **Issuer:** can be (1) an IDI and/or a wholly owned subsidiary of this IDI (the so-called "direct issuance structure") or (2) a newly created bankruptcy SPV ("SPV structure"). Issuance authorisation must be provided by the IDI's primary federal regulator. Only well-capitalised IDIs may issue covered bonds.

> **Cover assets:** are owned by the IDI and remain on balance sheet, but must be clearly identified and provide a first priority claim to covered bond holders. The issuer must enter into a Specified Investment contract with one or more financially sound counterparties which, in case of issuer default or FDIC repudiation, will continue to pay interest and/or principal accordingly as long as proceeds from cover assets at least equal the par value of covered bonds.

> **Covered bond terms:** must be between one and 30 years; issuance may be in any currency as long as currency risks are hedged; bonds can be fixed or floating. Interest rate swaps may be entered for hedging purposes with financially sound counterparties, which must be disclosed to investors. SEC registration is possible but not a requirement.

> **Eligible assets:** must be performing first-lien residential mortgages on one-to-four family residential properties with 80% maximum LTVs. Underwriting must be at the fully indexed rate, with documented income and in line with the existing supervisory origination guidance. Any loan that has been non-performing for more than 60 days should be replaced. A single Metro Statistical Area must be a maximum 20% of the cover pool.

> **Over-collateralisation (OC):** must be at least 5% of outstanding covered bonds at all times. When calculating the cover pool value, loans with a LTV exceeding 80% are still eligible but up to the 80% LTV limit only. LTVs must be indexed on a quarterly basis using a nationally recognised, regional housing price index or other comparable measurement.

> **Issuance limit:** is capped at 4% of the IDI's liabilities after issuance.

> **Asset Coverage Test (ACT):** must be performed on a monthly basis by an independent Asset Monitor to safeguard the quality and adequacy of the cover pool. Results must be made public. The asset monitor must also periodically check the accuracy of the ACT. Any ACT breach must be remedied within one month. If not after one month, the Trustee may terminate the program and return principal and accrued interest to covered bond investors. During an ACT breach, no covered bond can be issued.

> **Disclosure:** must be monthly. If substitute assets account for more than 10% of the cover pool within any month (or 20% within any quarter), the issuer must provide updated information on cover assets to investors. Any material information on the IDI's or SPV's financial profile or on any other relevant area must also be made public.

> **Independent trustee:** must be designated by the issuer to represent the interests of covered bond investors and enforce their rights over the cover pool in case of issuer insolvency. All covered bond holders backed by a common cover pool rank pari passu.

> **Insolvency procedures:** the FDIC has three options at its disposal: (1) covered bonds are repaid according to initial terms; (2) covered bonds are paid off in cash, up to the value of the pledged collateral;

(3) liquidation of the pledged collateral is permitted to pay off the covered bonds. Options (2) and (3) occur in case of default or FDIC repudiation as mentioned above. In such cases, covered bond holders will recover up to the value of the collateral. Any collateral excess must be returned to the FDIC, while covered bond holders rank pari passu with unsecured debt holders for the amount due in the event of a shortfall.

II. TWO KEY LEGISLATION ATTEMPTS SO FAR

United States Covered Bond Act

The 112th Congress saw an active push for the establishment of covered bond legislation in the US during 2011. The United States Covered Bond Act of 2011 was the most concerted attempt yet in that respect, although it never completed the full legislative process. For legislation to become law, identical text needs to be approved by both the House of Representatives (HR) and the Senate, and the final legislative text has to be signed by the President to become law. This was not the case as the Bill approved at the HR ("H.R. 940") contained some differences from that introduced at the Senate ("S. 1835") despite their similarities. These were as follows: an expansion of the definition of eligible issuers; for issuers that are not subject to the jurisdiction of a federal banking agency, the covered bond regulator would be the Board of Governors of the Federal Reserve System rather than the Secretary of the Treasury; a right afforded to the respective covered bond regulator and a majority of covered bond holders to replace the independent asset monitor; the omission of tax provisions. Furthermore, the start of the 113th Congress on 3 January 2013 meant that it needed to be re-introduced.

The US Covered Bond Act, whether in its "H.R. 940" or "S. 1835" format, contained major differences from the FDIC and US Treasury's foundations, especially with respect to the following points:

> **Covered bond regulators:** must be the Federal banking agency where appropriate, otherwise the Board of Governors of the Federal Reserve System ("S.1835") or the Secretary of the Treasury ("H.R. 940").

> **Eligible assets:** consist of any first-lien residential mortgage loan secured by a one-to-four family residential property but also (1) any residential mortgage loan insured or guaranteed e.g., under the National Housing Act; (2) commercial mortgage loans (including multi-family); (3) public sector assets – namely any bond or loan from or insured/guaranteed by a State, municipality or other governmental authority; (4) any auto loan or lease; (5) any student loan (guaranteed or unguaranteed); (6) any extension of credit to a person under an open-end credit plan; (7) any loan made or guaranteed by a small business administration; (8) any asset designated by the Secretary, by rule and in consultation with covered bond regulators.

> **Eligible issuers:** include any FDIC depository institution (or subsidiary), bank or savings and loan holding companies (or subsidiary) but also registered nonbank financial companies such as any intermediate holding company. "S.1835" widens eligible issuers to brokers or dealers and supervised insurers as well.

> **Substitute assets:** are limited to 20% of cover assets and may be cash, direct obligations of the US State or GSE of the highest credit quality.

> **Issuance limit:** must be established upon the soundness of the underlying issuer while the maximum amount of covered bond to be issued must be defined as a percentage of the issuer's total assets (with a possible review of this cap, whether up or down, on a quarterly basis).

> **Over-collateralisation:** must meet the minimum defined by the Secretary for each asset class but no specific amount is mentioned. Cover pool must be single asset only.

> **Insolvency procedures:** gives specific powers to the FDIC which, if appointed as a conservator or receiver prior to a default event, shall have an exclusive right during the one-year period beginning on the date of the appointment to transfer any cover pool owned by the issuer in its entirety, together with all covered bonds and related obligations. During that year, the FDIC shall ensure the full and timely payment of covered bond holders.

> In case of default prior to conservatorship or receivership, a separate estate shall be created for each affected covered bond programme which comprises all related cover assets and covered bonds. This estate is fully liable for covered and other secured obligations only. In case of collateral insufficiency, covered bond holders retain a residential claim against the issuer.

The PATH Act

In 2013, political interest in covered bond legislation emerged again as part of broader reform initiatives addressed in the Protecting American Taxpayers and Homeowners (PATH) Act. PATH has aimed notably to reform GSEs in order to prevent any future liability to taxpayers and increase mortgage competition, enhance transparency and maximise consumer choices. Details related to covered bonds in the PATH Act have been similar to the US Covered Bond Act of 2011, with the Treasury being proposed as a regulator instead of the Fed. However this bill, a Republican initiative, has lacked bipartisan support unlike the previous one, notably as it foresees the wind-down of GSEs, and has been thus another unsuccessful attempt so far.

III. WHERE DO WE STAND?

Covered bonds were mentioned twice by legislators since these attempts. First, a speech made in the summer 2014 by the US Treasury secretary, Jack Lew, revived hopes of US covered bond legislation as the US government was looking for private solutions to support mortgage lending. In a survey published by the US Treasury for market feedback, the emphasis was on private residential mortgage-backed private label securities (PLS) and thus not directly targeted at covered bonds. However, they were seen as complementary with a new attempt at covered bond legislation possibly emerging from the political debate.

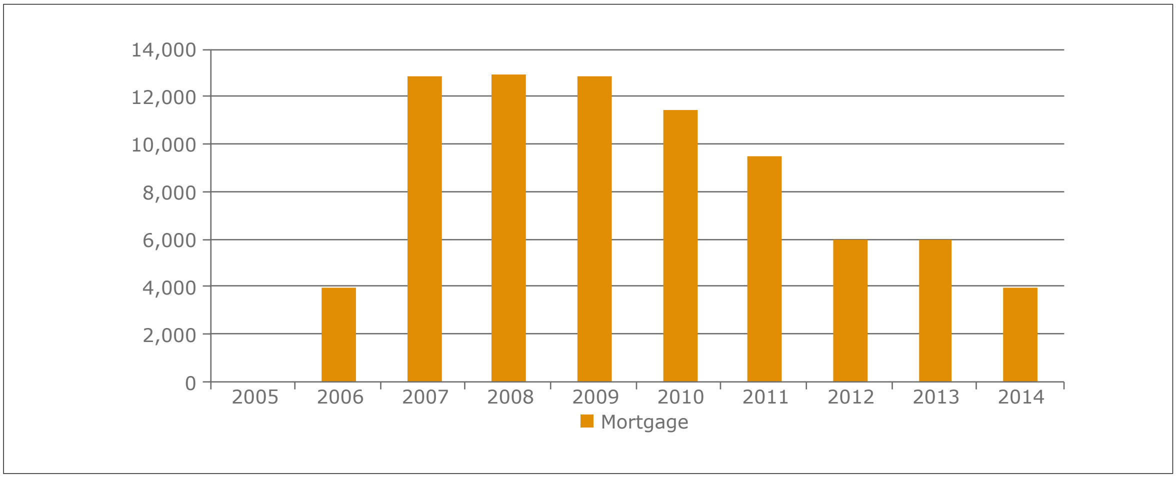
Second, more recently, the oversight plan of the Committee on Financial Services for the 114th Congress, which was released in January 2015, mentions covered bonds. As stated in the document, "The Committee will examine the potential for covered bonds to increase mortgage and broader asset class financing, improve underwriting standards, and strengthen U.S. financial institutions." As such, covered bonds might still have a role to play in the US, although this examination is part of a much longer agenda including the examination of Governments Sponsored Enterprises (GSEs) to which covered bonds have been tied to until now.

IV. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

US covered bonds are neither UCITS 52(4)-compliant nor CRR-compliant given the absence of EU membership.[1] Therefore, they do not benefit from preferred risk-weighting for regulatory capital purposes. Under the Standardised Approach, they are treated similarly to senior unsecured bank debt. That said, if denominated in €, US covered bonds are eligible for European Central Bank repo operations, conditional on an investment-grade rating. Specific haircuts are applied depending on the rating and characteristics of the covered bond.

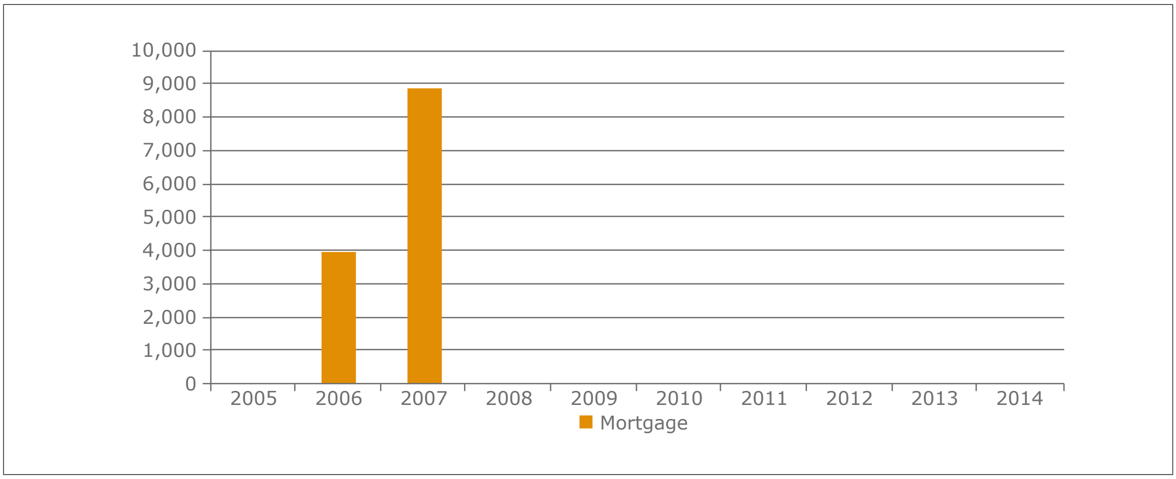
[1] Please click on the following link for further information on the UCITS Directive and the Capital Requirements Regulation (CRR): http://ecbc.hypo.org/Content/default.asp?PageID=504#position.

> Figure 1: Covered Bonds Outstanding, 2005-2014, EUR m



Source: EMF-ECBC

> Figure 2: Covered Bonds Issuance, 2005-2014, EUR m



Source: EMF-ECBC

ECBC Comparative Database: http://www.ecbc.eu/framework/57/US_Covered_Bonds.

CHAPTER 4 - RATING AGENCIES & METHODOLOGY

4.1 CREDIT RATING AGENCY APPROACHES

By Boudewijn Dierick, BNP Paribas, Moderator of the ECBC Task Force on Long-Term Financing & Chairman of the ECBC Rating Agency Approaches Working Group

In a year dominated by potential Grexit and Brexit, the European Central Bank (ECB) covered bond purchase programmes, the Bank Recovery and Resolution Directive (BRRD) together with the bail-in resolutions and their impact on covered bonds, it is clear that even when rating agencies do not change their covered bond criteria, covered bond ratings can still significantly change due to other factors.

A few of these factors, as well as other trends and topics related to the ratings of covered bonds observed in the past 12 months following July 2014, are worth highlighting in this respect:

> **Rating agency criteria changes for covered bonds are driven by the implementation of resolution regimes and the exemption of covered bonds from bail-in as outlined in the BRRD**. Various rating agencies have adjusted their methodology to take into account the favourable treatment and exemption of covered bonds from bail-in. The changes in methodology of rating banks have had a significant impact on certain covered bonds with completely different directions depending on the rating agency. In most cases, this has resulted in upgrades due to the higher starting points of the analysis, previously set at the senior unsecured rating or slightly higher, combined with a larger number of notches of delinkage possible from the issuer rating. Moody's was the first to roll out the so-called counterparty risk ratings replacing the senior unsecured ratings as a starting point of their analysis. This, combined with the extra notch uplift in countries that are implementing the BRRD, meant that the new anchor point in the Moody's covered bond rating analysis can be higher than the counterparty risk rating, which is in most cases 1 or 2 notches above the senior unsecured rating. This resulted in upgrades of various covered bond programmes in Ireland, the Netherlands, Norway, Italy and Germany. Standard & Poor's (S&P) changed their methodology significantly to give more weight to the exemption of covered bonds from bail-in in some countries while having additional notching depend on the strength of legal framework and importance of covered bonds in a specific jurisdiction, as well as the support that can be expected from the particular sovereign. Fitch Ratings lowered various bank ratings in June 2015 after taking out the sovereign support from the senior default ratings which it uses as starting point for the analysis of covered bonds. This led to downgrades of various covered bond ratings. DBRS published a request for comment on their new methodology for rating covered bonds in May 2015 also giving more weight to the covered bond legal framework in light of the BRRD and the importance of the product at national level. This might result in an uplift of their covered bond attachment point up to two notches above the senior unsecured rating. The second main building block of the covered bond ratings, used by all rating agencies, still remains the collateral support. The focus continues to be on giving additional notches uplift mainly for high recovery prospects and the mitigation of credit risk.

> **Upgrades of sovereign ratings and ceilings**. The improving trend in sovereign ratings and related country ceilings of covered bond ratings in peripheral Europe has resulted in various upgrades of covered bond ratings, often by multiple notches at a time. As covered bonds are often rated at the highest possible rating level in a given country (the lower of Aaa or country ceiling), an improvement of the country ceiling often results in upgrades of the covered bond ratings in the respective country. Various rating agencies, especially Moody's, have been upgrading the ratings and ceilings of countries such as Spain, Portugal, Ireland and Italy. These upgrades of the country ceilings were often combined with an improvement in the timely payment indicator (TPI) leading to even more notches of uplift. This has allowed many covered bonds out of these countries to become eligible for the LCR at Level 1, requiring a minimum rating of AA- or equivalent.

- **Conditional pass-through covered bonds** (CPTCB) have not only been attracting a lot of attention recently, but also various followers that have put in place new programmes. Van Lanschot in the Netherlands was the second issuer after NIBC while in Italy UniCredit has set up a new CPTCB programme and MPS is transforming its programme into CPTCB programme via consent solicitation.
- **Soft-bullet becomes the new market standard**. As expected, the trend of issuing soft- bullets has continued to gain momentum with new issuers, such as Singapore, Korea and Canada, using this format. Some existing issuers have switched to soft-bullets for the new series they issued (BNPP, CA) or even set up a new programme (ING) and for the first time we have seen issuers also switching their outstanding series of covered bonds into soft-bullets via consent solicitations (ABN, CS).
- **Reduction of counterparty linkage and dependence on rating agency triggers**. The (potential) risks of collateral posting required in case of a downgrade, as well as the costs of these risks driven by new LCR requirements, have resulted in various issuers trying to minimise the impact by reducing the number of hedges in their programmes. Some issuers have switched from perfect hedging using a cover pool swap and covered bonds swaps into 'natural' hedging without interest rate swaps or only swapping part of the cover pool.
- **Clearing remains subject to ongoing discussion** but at least there is now more general awareness of the potential impact of obligatory clearing on the covered bond market as well as potential clearing problems that warrant the exemption for covered bond swaps from central clearing, as is required by the European Market Infrastructure Regulation (EMIR).

Besides DBRS and the other three main credit rating agencies, we would like to welcome Scope Ratings as a new entrant in this year's edition of the ECBC Covered Bond Fact Book. Scope Ratings started covering the covered bond market by publishing its criteria for rating covered bonds in Q2 2015.

In view of the fact that five different credit rating agencies have modified, tweaked or completely changed their covered bond criteria over the past years, we thought it useful for the readers to provide the following summary table comparing the main building blocks of the approaches of each rating agency in a simplistic but hopefully useful and transparent way.

RATING AGENCIES

Building Block Towards Rating	Fitch	Moody's	S&P	DBRS	Scope
Minimum Rating (Starting Point):	IDR (Issuer Default Rating)	Counterparty (CR) Rating (SUR + 0-2)	ICR (Issuer Credit rating)	CB AP (Covered Bond Attachment Point = SUR)	ICSR (Issuer's Credit Strength Rating)
Additional Notches via: **CB Law**					
EU's BRRD or equivalent	uplift 0-2 notches	uplift 1 notch	uplift 1-2 notches = RRL (Rating Reference Level)	–	Taken into account in Recovery Regime
segregation/ bankruptcy remote systemic importance/ jurisdictional support	D-Cap (Discontinuity Cap) (max +6 notches)	TPI (Timely Payment Indicator) (max +6 notches)	RRL + max 3 notches (systemic importance; legal framework; sovereign credit capacity)	LSF (Legal Strength Framework) (max +6 notches) (A(low) needed)	Legal Framework (+2 notches) Recovery Regime (+4 notches)
Cover Pool/ Asset Quality	credit given for recovery (+0-2 notches) (max 3 for non-IG)	no additional credit given	uplift of 1-4 notches +2 for credit risk; +2 for refinancing costs	CPCA (Cover Pool Credit Assessment) +0-2 notches for high recovery prospects	Cover Pool Analysis +0-3 notches
5-7 Maximal Rating Possible above Starting point: ***(achievable with CPT Delinkage or appropriate liquidity mitigants)***	8+2 notches	6+3 notches	7+2 notches	6+2 notches	6+3 notches
Capped by Country Ceiling	✓	✓	✓	NO	NO (Macroeconomic factors & credit quality main factors)
OC Commitment/ counterparty risk/ hedging	published *breakeven OC* for given CB rating (= percentage below which CB would be downgraded) gives credit for *contractually committed OC* might be penalised (-1 notch) by *OC stress testing*	gives credit for contractually committed OC above min level required by legislation	*uncommitted OC:* max rating -1 notch *counterparty or country risk* might limit max rating if adequately mitigated/ hedged	gives credit for contractually *committed* OC above min level required by legislation	*ICSR BBB or more:* currently available OC; *below BBB:* take into account the robustness of communication of OC to market

4.2 DBRS COVERED BOND RATING METHODOLOGY

By Vito Natale and Claire Mezzanotte, DBRS

INTRODUCTION

As described in the rating methodology "Rating European Covered Bonds", DBRS covered bond ratings are composed of the following four building blocks:

1. Covered Bonds Attachment Point (CBAP);
2. Assessment of each covered bond programme's Legal and Structuring Framework (LSF);
3. Cover Pool Credit Assessment (CPCA), and
4. Credit for high recovery prospects provided by the cover pool.

DBRS assigns a rating to a covered bond issuance using a step by step process. The first step is to determine the LSF-implied Likelihood (LSF-L) for a covered bond programme based on the CBAP, LSF assessment and CPCA. Once the LSF-L is determined, a rating can be assigned to the covered bond issuance incorporating any credit for the ability of the cover pool (CP) to provide substantial support following an assumed default of the covered bonds (CBs).

THE FOUR BUILDING BLOCKS

1. Covered Bonds Attachment Point (CBAP)

CBs are characterised by dual recourse. The payment obligation falls initially on the debtor of first recourse, called the Reference Entity (RE), and failing that on the CP as a source of payment on the CBs. The RE is generally the issuer of the CBs, as well as the originator of the cover assets. However, in certain issuance templates it could be the parent company of a banking group which provides support or a guarantee to a subsidiary that, in turn, issues the CBs; it could also be an entity which is obligated to pay under a specific structure. In the latter cases, the recourse to the RE may be less evident but still present.

2. Legal and Structuring Framework (LSF) assessment

The LSF assessment is programme-specific and limits the number of notches a covered bond rating can achieve above the CBAP.

Qualitatively, DBRS's assessment of the LSF captures the likelihood that payment obligations under the CB could be smoothly and efficiently transferred from a troubled bank to another bank or to the CP, administered by a third party. This assessment takes into consideration the following three areas:

> Robustness of the CP segregation for the benefit of CB holders;

> Accessibility of CP cash flows on a preferential and timely basis, the need and ability to liquidate the CP, including likelihood of systemic support; and

> Contingency plans, including the involvement and responsibility of the regulator or the relevant Central Bank to facilitate the transfer, and regulator's support to the CB market.

CP segregation

DBRS recognises that CB legislation is written to supersede the bankruptcy and insolvency laws within a jurisdiction. CB legislations generally give CB holders a special privilege over the CP assets, which takes preference over claims of any other creditor in the case of issuer insolvency. In the event of an insolvency, legislation typically allows for the segregation of the CP from the bankruptcy estate. DBRS expects CB programmes that are not structured based on specific CB legislation to typically address the issue of segregation. As such, DBRS does not expect CP segregation to be a major constraining factor for CB ratings. If there were serious doubts about the CP segregation being effective to an acceptable extent, the dual recourse principle might be undermined and the structure may not be rated according to DBRS covered bonds methodology. Instead, DBRS generally expects that the issue of segregation will largely be addressed, either by operation of law or by structural features, and there may be residual sources of concern which can have a limited impact on DBRS's assessment. DBRS will draw a decreasing degree of comfort from a legal framework and structures where such sources of leakages in the segregation mechanism are prominent or are not effectively mitigated.

Timely access to the CP cash flows

A reasonable expectation that the cover assets will be available to satisfy the claim of the CB holders following a default of the RE is a first step toward gaining comfort that the CB holders will be paid according to the terms of their investment. DBRS carries out a qualitative analysis of the legal framework, structural features and specific characteristics of each CB programme, as well as expectations of systemic support, in order to achieve this comfort.

In general, and in particular in the case of a CP composed of mortgage loans, the cover assets amortise over a time horizon that is beyond the scheduled amortisation of the liabilities. While the RE is able to meet payments on the CBs, the resulting mismatches in the maturity profile are not of importance, as the RE will use its own sources of funds to meet maturing liabilities. Upon the failure of the RE, the source of payment switches to the CP. Therefore, DBRS carries out an analysis to understand the effective mismatches (as the conditions of the CB may provide for these to be modified conditionally to a default of the RE) and the manner in which they might be bridged.

The qualitative analysis aims at assessing the extent to which the CP composition, the programme's structural features and the legal framework interact to facilitate the CB investors' receipt of timely payments from the CP in a scenario where the RE is assumed to halt payments. This depends on the interaction of the constraints imposed by the programme structure and legal framework on how quickly the payments would need to be redirected to CB holders and how quickly sources of financing could become available to fund such needs. Some issues considered as part of the analysis are the type of assets that may need to be liquidated and the time it takes to liquidate them; maturity extension or prematurity test or other features which may allow for more time to explore alternative solutions and how the programme structure foresees the CP detaching from the influence of the RE in this timeframe.

Contingency plans and supervision

DBRS views positively the regulator's involvement and the existence of contingency plans for the smooth transition from the RE to the CP as a source of payments to CB holders. Factors reviewed to assess a regulator's involvement and contingency plans include, but are not limited to: the existence of a specific supervisor in charge of the CB programme in the normal course of operations, and the quality and content of the contingency plans in case of an issuer's default.

After reviewing these main factors under the LSF assessment, DBRS assigns the CB one of the five LSF assessments: Very Strong, Strong, Adequate, Average and Modest.

3. Cover pool credit assessment and overcollateralisation

Once a CBAP and an LSF assessment have been assigned to a CB programme, it is necessary to assess the quality of the CP in order to determine the LSF-L of the programme. This represents the likelihood that the CBs issued under a programme will be repaid according to their terms, provided there is sufficient overcollateralisation (OC) to which DBRS could give credit.

DBRS models the wind-down of the CP and the repayment of the liabilities according to their conditions. The aim is to determine whether CBs can be paid timely interest and principal solely from the CP (including any structural enhancement) for a given rating scenario.

The CP credit assessment is similar to the analysis of a securitisation (for a pool of similar assets) such as RMBS, and SME CLOs. It begins with an estimate of the probability of default (PD) and loss given default (LGD) for each rating category based on the methodology applicable to the underlying assets, followed by an analysis of the stressed asset cash flows (including interest rates and exchange rates) from the underlying assets and an analysis of the manner in which the cash flows are allocated to the liabilities based on the transaction documents.

Additionally, the CP credit assessment accounts for the timing of RE discontinuing its payments. This warrants an analysis of the periodic defaults on the underlying collateral versus a lifetime default expectation; assumptions regarding principal amortisation and reinvestment, future level of interest and exchange rates and senior costs; assumptions about collections in case of the RE's default under its obligations; and an estimate of the liquidation value of the underlying collateral in the event of the RE's default or inability to pay. In order to estimate liquidation values, DBRS performs a net present value calculation based on projected cash flows generated by the CP and assumed interest rates stresses and market value spreads.

The CP credit assessment is the rating stress scenario that the structure can withstand given the overcollateralisation (OC) to which DBRS gives credit.

Due to the very nature of the product, the OC level changes, for instance, as a result of the amount of CBs issued or amortised under the programme, and assets added to or removed from the CP. Generally speaking, the only legal obligation of the issuer or RE is to maintain a level of assets such that the regulatory tests are satisfied and the minimum level of OC legally or contractually required is maintained.

Therefore, DBRS relies on the minimum level of OC required by the national legislation or the secondary regulation and regulators' guidelines. This point seems to be supported by the Bank Recovery and Resolution Directive (BRRD). However DBRS's conclusion might be affected by the implementation of the BRRD in the local legislative framework. DBRS considers the form of commitment by the issuer or the RE to maintain the OC when considering the level of OC it gives credit to in its analysis, and may apply scaling factors to observed OC levels in certain cases. For instance, when a contractual undertaking of the issuer or RE is in place to maintain a certain level of OC, and non-compliance with such undertakings would cause the RE to be in breach of contract under the programme documentation, DBRS gives full credit to such contractual undertaking. However, if there is no public announcement, then DBRS determines a sustainable level of OC by reference to the minimum observed OC level during the past 12 months, adjusted by any increase that DBRS judges to be persistent. This figure is then reduced by the following scaling factors, which vary with the CB's rating:

CBs rating	Scaling factors (x) to observed OC
AAL and above	0.85x
AL to AH	0.90x
BBBL to BBBH	0.93x
Below investment grade	0.95x

Some issuers may publish a public announcement for a target OC level (e.g., in the form of a press release, or a statement in the investors' report or on the RE website). DBRS views such announcements as less strong compared to an issuer's legal or contractual obligation. Therefore, the analysis will typically apply the above-detailed scaling factors to the publicly announced level of OC. However, when DBRS holds the view that the announced level of OC can be considered persistent based on historically observed levels, the analysis may give full credit to it.

4. Credit for high recovery prospects provided by the cover pool

In consideration of the essentially senior secured position of CB holders, DBRS may give up to two notches of uplift from the LSF-L if the CP analysis shows that it would provide substantial support following a default of the CBs.

DBRS runs a wind-down cash flow simulation aimed at covering the cost of funding under a stress scenario in line with the CB rating. Then DBRS determines the percentage of principal payments received under the CBs versus their nominal amount, and assign a CB rating with an uplift from the LSF-L according to the following scale:

% of principal recovered	Notches uplift
>= 80%	+2
>= 60% but < 80%	+1
< 60%	0

SOVEREIGN STRESS

A sovereign downgrade may impact the individual factors considered in a CB rating and may result in a potentially amplified impact on the rating of the CBs:

1. CBAP: the issuer rating takes into consideration the operating environment of a banking organisation (including regulatory and supervisory regime), as well as some expectation of systemic support from governments. As a result, a sovereign downgrade may have an impact on the rating of the RE in terms of a more challenging operating environment, as well as a lower ability or willingness of the sovereign to provide support. This can lead to a downgrade on the CB ratings.

2. LSF assessment: the LSF assessment expresses the likelihood of a smooth transition from the issuer or RE to the CP as a source of payments on the CB. A downgrade of the domicile sovereign may affect the LSF assessment associated with a given programme and therefore cause its downgrade. In the case of a CP composed of sovereign exposures, a downgrade of the domicile sovereign may affect the LSF assessment as DBRS assesses less favourably exposures to lower-rated sovereigns. In certain circumstances, a downgrade of the host sovereign may also affect the LSF assessment.

3. CP credit assessment: a downgrade of the domicile sovereign may cause a deterioration of the CP assets. It can also trigger greater volatility in the financial markets and result in DBRS factoring in higher levels of market value spreads into its cash flow modeling. This would in turn increase the pass-OC level for a given rating scenario. DBRS may then downgrade the CB even if the level of OC to which DBRS can give credit is unchanged, but it is now lower than the new pass-OC level.

4. Support provided by the CP: for reasons similar to those expressed under point (3) above, a downgrade of the domicile sovereign may affect the notching granted above the LSF-L.

DBRS LSF MATRICES

DBRS considers the probability of default of a CB as a function of the joint probability of the RE discontinuing its payment obligations and the CP's inability to meet the payments. DBRS also assumes that there will usually be a correlation between these two instances. Separately, DBRS also assumes a non-zero probability that the CB will not receive the full benefit of the cash flows from the CP rapidly enough to avert a CB default.The five categories are assigned so as this probability of not receiving the CP's full benefit) increases as the LSF weakens.

Based on these, DBRS has generated five LSF matrices for each of the LSF grades with a fixed assumption of a CB with a five year weighted average life (WAL). (See Figure 1 for an example of the five matrixes). The output of the DBRS matrixes (or the LSF-L) points to the CB rating level for each one of the CBAP and CP credit assessment levels for a given LSF assessment. The LSF-L does not reflect the prospect for high recoveries for the CP following a potential default of the CB, which may provide up to an additional two notches uplift to the LSF-L.

COUNTERPARTY RISK

DBRS generally applies to European CB the same counterparty criteria as stated under *Legal Criteria for European Structured Finance Transactions* (counterparty criteria) and *Derivative Criteria for European Structured*

Finance Transactions (derivative criteria), with certain noticeable differences that reflect the nature of the product, that are detailed in the methodology.

COVERED BONDS SURVEILLANCE

Once DBRS assigns a rating on CBs issued under a programme, the surveillance process begins and is continued for as long as DBRS maintains a rating on the CBs, via a periodic review and a more frequent monitoring.

In cases where ongoing information is no longer deemed reliable or of sufficient quality, and DBRS is unable to properly monitor the transaction, DBRS may discontinue the existing rating(s).

RELATED RESEARCH

> “Rating European Covered Bonds”, December 2014. http://www.dbrs.com/research/275015/rating-european-covered-bonds.pdf.

> “Derivative Criteria for European Structured Finance Transactions”, October 2014. http://www.dbrs.com/research/272784/derivative-criteria-for-european-structured-finance-transactions.pdf.

> “Legal Criteria for European Structured Finance Transactions”. December 2014. http://www.dbrs.com/research/275507/legal-criteria-for-european-structured-finance-transactions.pdf.

> Commentary: “The Effect of Sovereign Risk on Securitisations in the Euro Area”. May 2012.

> Commentary: “Spanish Mortgage Covered Bonds: Legal and Structuring Framework Review”. December 2014. http://www.dbrs.com/research/275018/spanish-mortgage-covered-bonds-legal-and-structuring-framework-review.pdf.

> Commentary: “Portuguese Covered Bonds: Legal and Structuring Framework Review”. December 2014. http://www.dbrs.com/research/275026/portuguese-covered-bonds-legal-and-structuring-framework-review.pdf Commentary: “Italian Obbligazioni Bancarie Garantite Legal and Structuring Framework”. December 2014. http://www.dbrs.com/research/275023/italian-obbligazioni-bancarie-garantite-legal-and-structuring-framework.pdf.

> Commentary: “Irish Covered Bonds Legal and Structuring Framework”. December 2014. http://www.dbrs.com/research/275028/irish-covered-bonds-legal-and-structuring-framework.pdf.

> Commentary: “French Covered Bonds: Legal and Structuring Framework Review”. March 2015. http://www.dbrs.com/research/277383/french-covered-bonds-legal-and-structuring-framework-review.pdf.

> FIGURE 1: ADEQUATE LSF – COVER POOL CREDIT ASSESSMENT

		AAA	AA (high)	AA	AA (low)	A (high)	A	A (low)	BBB (high)	BBB	BBB (low)	BB (high)	BB
COVERED BOND ATTACHMENT POINT	**AAA**	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA
	AA (high)	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AA (high)	AA (high)	AA (high)	AA (high)	AA (high)
	AA	AAA	AAA	AAA	AAA	AAA	AAA	AA (high)	AA	AA	AA	AA	AA
	AA (low)	AAA	AAA	AAA	AAA	AA (high)	AA (high)	AA	AA	AA (low)	AA (low)	AA (low)	AA (low)
	A (high)	AAA	AA (high)	AA (high)	AA (high)	AA	AA	AA	AA (low)	AA (low)	A (high)	A (high)	A (high)
	A	AA (high)	AA (high)	AA (high)	AA	AA	AA	AA (low)	AA (low)	AA (low)	A (high)	A	A
	A (low)	AA	AA	AA	AA (low)	AA (low)	AA (low)	A (high)	A (high)	A (high)	A	A (low)	A (low)
	BBB (high)	AA (low)	AA (low)	A (high)	A (high)	A (high)	A (high)	A	A	A (low)	A (low)	A (low)	BBB (high)
	BBB	AA (low)	A (high)	A (high)	A (high)	A	A	A	A (low)	A (low)	A (low)	BBB (high)	BBB (high)
	BBB (low)	A (high)	A (high)	A	A	A	A	A (low)	A (low	A (low)	A (low)	BBB (high)	BBB (high)
	BB (high)	A (low)	A (low)	A (low)	A (low)	A (low)	BBB (high)	BBB (high)	BBB (high)	BBB	BBB	BBB (low)	BBB (low)
	BB	A (low)	A (low)	A (low)	BBB (high)	BBB (high)	BBB (high)	BBB (high)	BBB	BBB	BBB (low)	BBB (low)	BBB (low)
	BB (low)	BBB (high)	BBB (high)	BBB (high)	BBB (high)	BBB (high)	BBB	BBB	BBB (low)	BBB (low)	BBB (low)	BBB (low)	BB (high)
	B (high)	BBB	BBB	BBB	BBB	BBB (low)	BBB (low)	BBB (low)	BBB (low)	BBB (low)	BBB (low)	BB (high)	BB (high)
	B	BBB (low)	BBB (low)	BBB (low)	BBB (low)	BBB (low)	BBB (low)	BBB (low)	BBB (low)	BB (high)	BB (high)	BB (high)	BB (high)
	B (low)	BBB (low)	BBB (low)	BBB (low)	BBB (low)	BBB (low)	BBB (low)	BB (high)	BB (high)	BB (high)	BB (high)	BB	BB
	CCC (high)	BB (high)	BB (high)	BB (high)	BB (high)	BB (high)	BB (high)	BB (high)	BB (high)	BB	BB	BB (low)	BB (low)
	CCC	BB (high)	BB (high)	BB (high)	BB (high)	BB (high)	BB (high)	BB (high)	BB	BB	BB	BB (low)	BB (low)
	CCC (low)	BB	BB	BB	BB	BB	BB (low)	BB (low)	BB (low)	BB (low)	BB (low)	B (high)	B (high)

Source: DBRS

4.3 FITCH RATINGS COVERED BOND RATING METHODOLOGY

By Carmen Muñoz and Beatrice Mezza, Fitch Ratings

INTRODUCTION

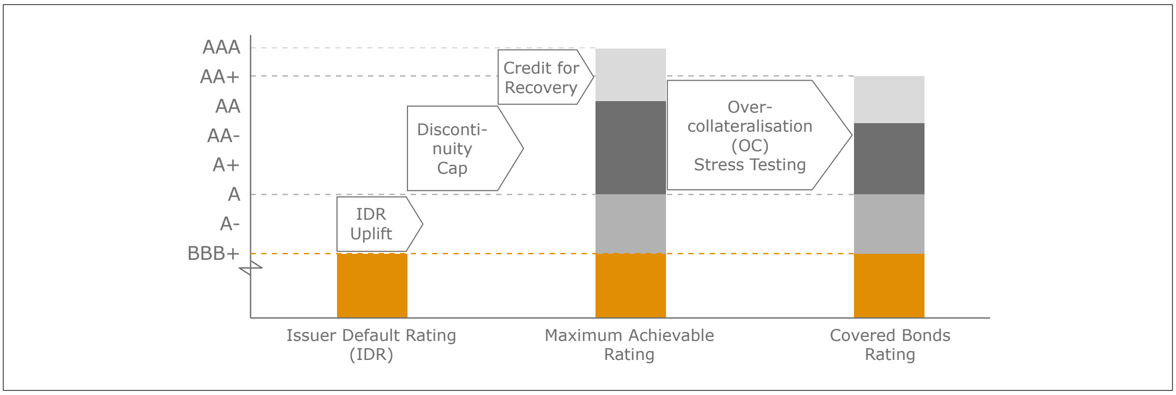
Fitch Ratings' covered bond rating methodology mainly address the instrument's probability of default (PD), but also incorporate recovery given default via the following steps.

1. **Setting the floor for the covered bond rating:** Covered bond holders have full recourse against an issuing financial institution and, as long as the issuer is solvent, it will pay covered bonds when due on a pari passu basis with its senior unsecured liabilities, irrespective of the performance of the cover assets. Hence, the covered bond rating on a PD basis will not be lower than the issuer's long-term issuer default rating (IDR). An IDR uplift is assigned to covered bonds from jurisdictions where they are exempt from bail-in. A restoration of an issuing bank to a going concern would avoid the source of covered bonds payments switching from the issuer to the cover pool, as covered bonds would continue to be serviced by their issuer even if they defaulted on their senior unsecured debt. The IDR, adjusted by the applicable IDR uplift, constitutes a floor for the covered bonds rating in terms of PD regardless of the level of protection through overcollateralisation (OC).
2. **Determining the maximum achievable covered bond rating:** Fitch's discontinuity (D-Cap) analysis evaluates the obstacles that may hinder a smooth transition from the issuer to the cover pool as the source of covered bond payments. The D-Cap conveys the maximum number of notches above the financial institution's IDR, as adjusted by any IDR uplift, that the covered bonds can achieve on a PD basis. The covered bond rating can further reflect stressed recoveries from the cover pool in the event of a covered bond default. The covered bond rating can in theory exceed the IDR by the number of notches corresponding to the sum of the IDR uplift, the D-Cap and the credit for recovery. However, the covered bond rating may be lower; at a level corresponding to the stress scenario that can be withstood taking into account the OC that Fitch gives credit to in its rating.
3. **Stress-testing OC:** Fitch models the wind-down of the cover pool following a hypothetical change in payment recourse from the issuer to the cover pool. Stressed, static asset cash flows are compared to the payments due on the covered bonds and privileged swap liabilities. Stresses include credit losses and prepayments of the assets, the cost of bridging maturity mismatches by disposing of assets and adverse interest and exchange rate and movements.

   The agency determines the OC level which supports the timely payment of covered bonds at the PD rating level and that which leads to a minimum percentage of recoveries given default at the covered bond rating level. Fitch publishes the breakeven OC for a given covered bond rating; it is the percentage below which the covered bonds rating would be expected to be downgraded. Since a given covered bond rating can be achieved via different combinations of rating on a PD basis and credit for recoveries, the agency will disclose as the tested rating on a PD basis the rating scenario in which timely payment on the covered bonds is met, as well as the particular combination corresponding to the calculated breakeven OC. The breakeven OC for the rating is compared with the percentage of OC which the agency gives credit to in its analysis.

Figure 1 illustrates the steps Fitch takes in rating covered bonds, which are detailed below.

> FIGURE 1: FITCH COVERED BONDS RATING STEPS


AAA
AA+
AA
AA-
A+
A
A-
BBB+
Credit for Recovery
Disconti-nuity Cap
Over-collateralisation (OC) Stress Testing
IDR Uplift
Issuer Default Rating (IDR)
Maximum Achievable Rating
Covered Bonds Rating

IDR: Issuer Default Rating; OC: Overcollateralisation; PD: Probability of Default

Source: Fitch Ratings

STEP 1: SETTING THE FLOOR FOR THE COVERED BOND RATING

Issuer Default Rating

Covered bond ratings are linked to the credit risk of the issuing financial institution, as measured by its Long-Term IDR. This is because of the dual recourse nature of covered bonds and the fact that assets and liabilities are dynamic and programmes can be affected by an issuer's decisions regarding cover pool composition, asset and liability mismatches and maintenance of OC.

IDR Uplift

Fitch can assign uplifts above the IDR of up to two notches if the issuer is rated in the 'BB' category or above, and up to three notches if the issuer rated below. This is dependent on the following factors:

> **Relative ease and motivation for resolution methods other than liquidation:** There is greater motivation for alternative resolution tools than liquidation to be applied if a bank is systemically important, with a high degree of economic interconnectedness within a country, or if it is a large, complex institution. The liquidation of such banks would be complicated, drawn out and risk wider financial market instability, while it could prove easier to liquidate smaller banks and specialised financial institutions without threatening financial stability.

> **Importance of covered bonds to a country's financial markets:** If covered bonds are important to a country's financial markets, Fitch expects that the greater political and regulatory incentives to avoid financial contagion will make alternative resolution more likely than liquidation. Fitch considers Germany, France, Spain, Norway, Sweden and Denmark to be covered bond intensive countries, based on measures such as the ratio of covered bonds to banking assets and domestic covered bonds in proportion to the total covered bonds market.

> **Level of an issuer's senior unsecured debt available for bail-in:** Long-term, wholesale distributed, senior unsecured debt that could be bailed-in serves as an additional buffer for covered bonds, if equity and other junior instruments prove insufficient to absorb losses. Where this is substantial, it further reduces the likelihood of the cover pool becoming the direct source of payment for the covered bonds. Fitch checks if the level of outstanding senior unsecured debt represents at least 5% of the total balance sheet, adjusted for insurance assets and derivatives.

A two-notch uplift will be granted if at least two of the three factors are present; a one-notch uplift will be granted if at least one of the three factors is present; and no uplift will take place if none of the three factors is present.

STEP 2: DETERMINING THE MAXIMUM ACHIEVABLE COVERED BONDS RATING

Setting Discontinuity Caps

Fitch's D-Caps are a qualitative assessment of payment interruption risk in the transition to the cover pool as a source of covered bond payments. The assigned D-Cap reflects the highest risk assessment between asset segregation, liquidity gap and systemic risk, alternative management and privileged derivatives. The possible D-Caps and their associated risk assessments, are as follows: 8 (Minimal discontinuity; for cases with no liquidity gaps), 6 (Very low), 5 (Low), 4 (Moderate), 3 (Moderate high), 2 (High), 1 (Very high) and 0 (Full discontinuity; for cases where a covered bond default is expected upon the enforcement of recourse against the cover pool).

> **Asset Segregation:** Fitch analyses the strength of the asset segregation mechanism. It considers whether OC is beyond the reach of other creditors until all covered bonds have been repaid in full. Other identified risks relate to the potential claw back of cover pool assets, commingling with the issuer's other cash flows and borrower set-off rights.

> **Liquidity Gap and Systemic Risk:** Incoming cash flows from the cover pool do not exactly match payments due on the privileged liabilities for most programmes. The analysis of this component considers liquidity risks, principal payment risks and systemic risks.
>
> Short-term liquidity shocks may arise from interest payments due shortly after the recourse to the cover pool has been enforced. Fitch expects programmes to provide protection that covers at least covered bond interest payments over the next three months on a rolling basis, plus a buffer to cover senior expenses and potential interest rate movements.
>
> In terms of principal payment risks, Fitch first compares the time needed to monetise cover assets in a stress scenario to the length of time granted by the programme's protection mechanism and also considers the strength of this mechanism. Protection against this risk can be offered via a maturity extension; pre-maturity tests; mandatory liquidity requirements; and access by the alternative manager to central bank market operations.
>
> Fitch also considers within systemic risk how a stressed macroeconomic environment would likely make it more difficult and time consuming to refinance cover assets.

> **Systemic Alternative Management:** The agency studies the legal or contractual provisions for replacing an insolvent institution as manager of the covered bonds and servicer of the cover assets. In particular the timing of the appointment of a substitute manager or government administrator is considered, as well as the scope of their responsibilities – whether exclusively focused on the interests of the covered bond holders or also encompassing other creditors, and if the alternative manager has all powers and means to take the necessary actions.

> **Cover-Pool Specific Alternative Management:** The cover pool-specific assessment focuses on the transferability of relevant data and IT systems to an alternative manager and buyer. Fitch evaluates the quality and quantity of data provided to the agency, whether cover assets, debtors' accounts and privileged swaps can be clearly identified within the issuing bank's IT systems, whether third-party rather than custom-made IT systems are used, the degree of automation and speed of cover pool reporting, as well as recordkeeping standards on loan documentation for cover assets and attached security. Dormant or wind-down programmes may attract a worse risk assessment.

- **Privileged Derivatives:** Fitch considers programmes encompassing privileged hedging agreements to be more vulnerable to a potential issuer insolvency. Unlike non privileged swaps entered into by the issuer, which would terminate upon an issuer event of default, privileged swaps remain obligations of the cover pool and swap counterparties generally rank pari passu with covered bonds. The agency differentiates between intra-group and external counterparties in its assessment as well as whether termination payments to swap counterparties rank pari passu with covered bonds.

Defining Recovery Uplift

Should covered bonds suffer a default after primary recourse switches to the cover pool, they may still benefit from high recoveries stemming from the remaining cover assets. Fitch recognises this through a potential uplift above the tested covered bonds' rating on a PD basis. For stressed recoveries estimated in the 91-100% range, the uplift can reach up to two or three notches depending on whether the tested rating on a PD basis is in the investment grade or speculative grade range (see Figure 2 below).

> Figure 2. Maximum notching above covered bond rating on a PD basis

Recovery Prospects	Recovery Range (%)	Investment Grade	Non-investment grade
Outstanding	91-100	+2	+3
Superior	71–90	+1	+2
Good	51-70	+1	+1
Average	31-50	-	-
Below average	11-30	-1	-1
Poor	0-10	-1/-2	-2/-3

Source: Fitch Ratings

In its recovery analysis, Fitch disregards any potential recourse to the bankruptcy estate of the issuer, because enforcement may be challenging if it starts substantially after the liquidation of the bank and it is difficult to predict the quality of non-cover-pool assets and the issuer's capital structure at the time of its liquidation.

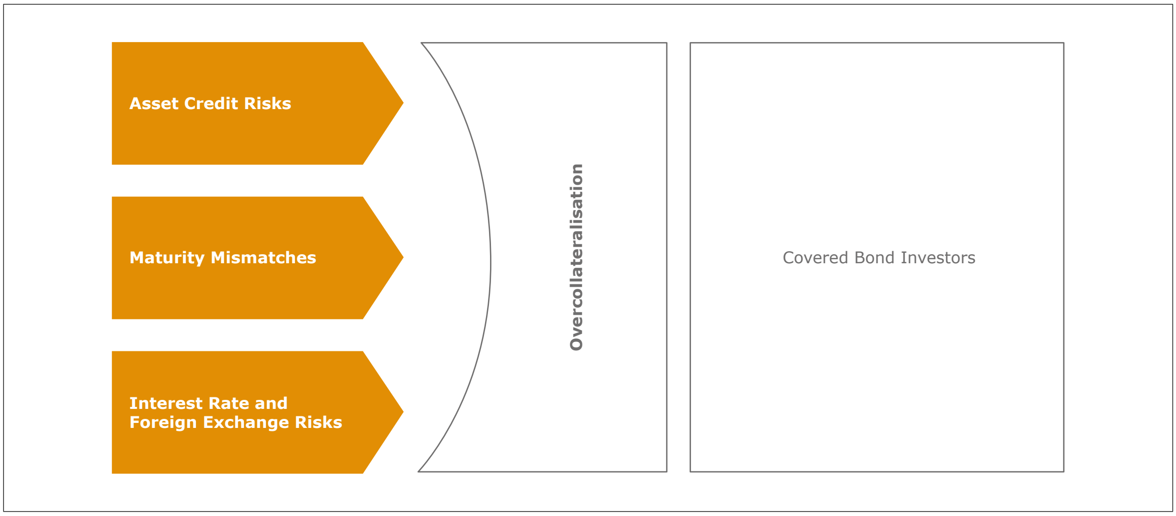
Sovereign related risk may also limit the maximum rating that the covered bonds can achieve. Public sector programmes are more exposed to sovereign-related risk than mortgage programmes due to the greater link between the sovereign and public sector debtors from the same country.

STEP 3: STRESS-TESTING OC

Fitch's cash flow model compares stressed incoming cash flows to payments due, assuming that the cover pool becomes static under the care of a third party manager, and that cash flows are trapped if not needed to pay covered bonds. The agency generally models the point at which recourse against the cover pool is enforced up to six quarters after the pool cut-off date and potentially shortly ahead of the next major upcoming maturity.

Fitch applies stress scenarios addressing three major sources of risk once recourse against the cover pool is enforced and for which OC serves as a protection (see Figure 3): i) the credit risk of the cover assets; ii) the cost of bridging maturity mismatches if any; and iii) adverse interest rate and foreign currency movements for open positions between the cover pool and covered bonds, after taking into account privileged swaps. This stress testing determines the breakeven OC for a given covered bond rating. Fitch splits the break-even OC for the rating into three components: cash flow valuation, credit loss and asset disposal loss.

> FIGURE 3. THREE MAJOR SOURCES OF RISK – COVER POOL PRIMARY SOURCE OF PAYMENT



Source: Fitch Ratings

Cash flow valuation

Fitch compares the asset and liability cash flows, incorporating the impact of privileged swaps. Future cash flows are discounted under a flat, high and low interest rate scenario. In a theoretical programme without margin or basis risk, floating rate assets and liabilities would be valued at par in any rating scenario, whereas fixed rate cash flows would be valued substantially below par in high interest rate scenarios and above par in low interest rate scenarios. The assets' cash flow profile is modified by applying Fitch's published high and low prepayment assumptions for the given asset class. The calculation takes into account the post swap excess spread earned on the assets, disregarding potential issuer-driven asset margin variations, but incorporating the effect of natural amortisation and product switches.

Credit loss

Fitch conducts a static analysis and forms assumptions about the cumulative defaults and recoveries expected to arise in a given rating scenario, over the life of a cover pool. The credit loss depends on the nature and geographical location of the underlying assets or obligors. Fitch applies the same models and criteria as in structured finance transactions for similar assets.

Asset disposal loss

When testing OC for the timely payment of covered bonds after an assumed enforcement of recourse against the cover pool, Fitch compares, at each period, the current balance of cash to the amount due on the covered bonds, taking into account features such as extendable maturities, if any. In case of a temporary surplus, excess cash is modelled to be invested at a sub-market rate, creating losses from negative carry.

In case of a shortfall of funds, asset sales, when appropriate, are simulated at a price below par. The sale price is calculated as the net present value of future asset cash flows, using the above-mentioned stressed interest rate, to which a stressed refinancing spread is added, and applying a minimum discount to the first sale.

Fitch's stressed refinancing spread assumptions represent the premium expected by a potential buyer/lender for the acquisition/refinancing of part of the cover pool. They are derived from observable sale prices on comparable assets where available, such as publicly traded sovereign and local debt. In the absence of pricing evidence for mortgage portfolio sales, Fitch uses secondary market spreads from residential mortgage-backed securities, covered bonds and other relevant securities as a reference. This is because the agency believes the most likely exit for an alternative manager would be to sell the cover assets to another financial institution that already originates similar assets and will have to bear this funding cost.

RELATIONSHIP BETWEEN OC AND RATINGS

The level of OC in covered bond programmes can change over time, as assets pay down and/or as issuers actively manage their pools. Fitch gives credit – in decreasing order of comfort – to the following (when available) in its cash flow analysis:

- Contractual commitments, if legally binding and enforceable against the issuer; and
- Non-contractual public statements and/or covenants – such as undertakings given in the programme's investor reports, the bank's annual reports, or published on the investor relations section of the issuer's web site; or
- The lowest level of OC recorded during the preceding 12 months, provided that the issuer's Short-Term IDR is at least at 'F2' and the programme is not in wind-down.

For issuers with a short-term IDR below 'F2', or for programmes Fitch considers to be in wind-down or dormant, in the absence of valid contractual or otherwise public statements, the cash flow analysis will be run by giving credit only to the minimum level of OC, if any, required by the relevant covered bond legal or contractual framework.

COVERED BONDS SURVEILLANCE

Fitch's covered bonds surveillance platform constitutes a single, comprehensive source of periodic information on key covered bond credit characteristics. It gives an overview of the IDR, the IDR uplift, the D-Cap and the covered bond ratings, including Outlooks, for all programmes publicly rated by the agency. A rating history window lists all past rating actions at programme level since rating inception. Users will further find the amount of outstanding covered bonds and corresponding cover assets, highlighting available nominal OC as of each reporting date, as well as the breakeven percentage of OC (or asset percentage) for the assigned rating.

The platform enables users to follow the composition of cover pools, such as geographical distribution for public sector assets or loan-to-value ratios for mortgage loans. Furthermore, the surveillance pages display indicators of maturity, interest rate and currency mismatches between the cover pools and the covered bonds.

In addition, the agency publishes a periodic snapshot which presents statistics about the universe of covered bonds rated by Fitch, including country-based sheets within the associated excel file.

Fitch Ratings' Applicable Covered Bond Criteria

> Covered Bonds Rating Criteria (8 August 2014).

> Covered Bonds Rating Criteria – Mortgage Liquidity and Refinancing Stress Addendum (20 May 2015).

> Covered Bonds Rating Criteria – Public Sector Liquidity and Refinancing Stress Addendum (29 January 2015).

> Counterparty Criteria for Structured Finance and Covered Bonds (14 May 2014).

> Counterparty Criteria for Structured Finance and Covered Bonds: Derivative Addendum (14 May 2014).

> Criteria for Interest Rate Stresses in Structured Finance Transactions and Covered Bonds (19 December 2014).

> EMEA RMBS Master Rating Criteria (31 March 2015).

> Criteria for the Analysis of Commercial Real Estate Loans Securing Covered Bonds (11 May 2015).

> Asset Analysis Criteria for Covered Bonds of European Public Entities (16 February 2015).

4.4 MOODY'S COVERED BOND RATING METHODOLOGY

By Jane Soldera, Nicholas Lindstrom and Juan Pablo Soriano, Moody's Investors Service

This chapter presents a high-level summary of certain aspects of the covered bond methodology currently used by Moody's Investors Service. For a full explanation of the methodology, please consult the report "Moody's Approach to Rating Covered Bonds", 16 March 2015, available at www.moodys.com.

OVERVIEW

Our rating for a covered bond is determined after applying a two-step process:

> Moody's Expected Loss Covered Bond Model (*EL Model*): This determines a rating based on a largely quantitative calculation of expected loss, taking into account (1) the issuer's credit strength relative to its covered bond obligations (the *CB anchor*) and (2) the value of the cover pool, should the issuer cease to make payments on the covered bonds.

> Timely Payment Indicator *(TPI) Framework*: This applies a ceiling to the rating arrived at using Moody's EL Model. The TPI framework determines the maximum covered bond rating based on (1) the issuer's credit strength as expressed by the CB anchor and (2) the TPI assigned to the programme. The TPI assigned will reflect the probability of timely payments continuing on the covered bonds if the issuer, or a rated entity supporting the issuer, ceases to make payments on the covered bonds. We refer to the issuer ceasing to support the covered bonds as a *CB anchor event*.

Ratings are assigned by a committee that further takes into account other credit-relevant features. For example, ratings are subject to sovereign risk considerations represented by the sovereign ceiling[1], and to legal risk considerations such as the risks of deposit set off by an underlying borrower against a cover pool loan, comingling of funds on issuer default and claw-back of cover pool loans by the issuer's insolvency estate.

MOODY'S EXPECTED LOSS (EL) MODEL

Our covered bond ratings are primarily determined by the expected loss under Moody's EL Model. The model assumes there is recourse, first, to the issuer and, second, to the cover pool. The model accordingly calculates the expected loss as a function of (1) the probability of a CB anchor event; and (2) the subsequent losses (if any) on the cover pool. Following a CB anchor event, the level of losses will be determined assuming a stressed environment where, most likely, the bank that originated the cover pool assets has failed. The key factors affecting the loss assumptions include:

> The credit quality of the assets in the cover pool;

> Refinancing risk, which arises when funds need to be raised to refinance the cover pool following a CB anchor event; and

> Any interest rate and currency mismatch risks to which the cover pool is exposed.

Moody's EL Model calculates expected loss on a month-by-month basis, from the point of issuance to the final maturity of a covered bond. For each period it calculates the probability of a CB anchor event on the basis of the issuer's credit strength, as expressed by the CB anchor, and the estimated loss on the collateral (if any) assuming the issuer has defaulted on the covered bonds. The results are then summed and discounted back to a net present value to give the overall expected loss on the covered bond.

MOODY'S EL MODEL – ROLE OF THE ISSUER

The issuer's role is crucial to the performance of a covered bond programme. Before a CB anchor event, we assume the issuer is performing its obligations and there should be no loss to covered bondholders. The prob-

[1] See "How Sovereign Credit Quality Can Affect Other Ratings"; 16 March 2015 at www.moodys.com.

ability of a CB anchor event is expressed by the level of the CB anchor, which is the measure of an issuer's credit strength relative to its covered bond obligations. To assess the CB anchor we look first at the issuer's counterparty rating (CR) assessment and, for the majority of covered bonds in Europe, the CB anchor will be the CR assessment plus one notch.

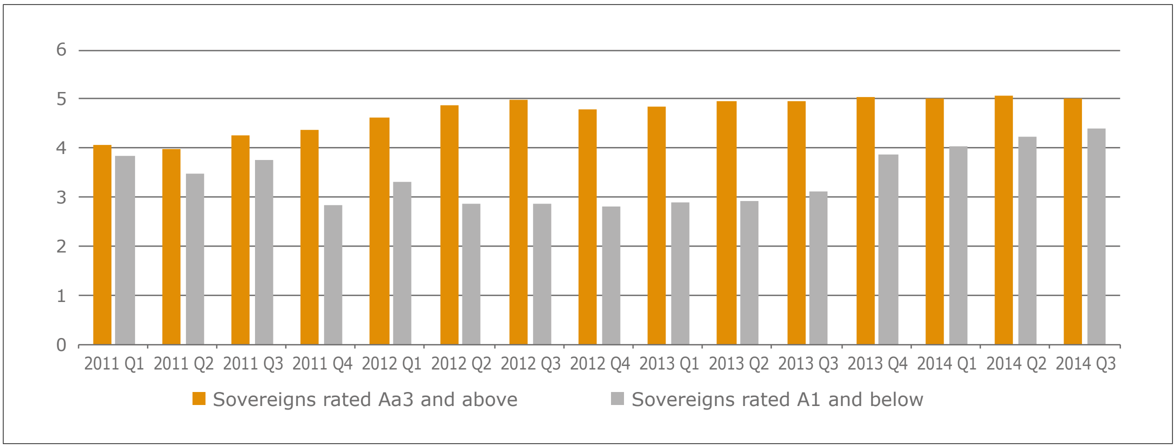
The CR assessment[2] applies to certain issuer obligations that, in a banking resolution[3], are likely to be honoured even while losses are imposed on senior unsecured debt or non-preferred deposits. The CR assessment expresses a probability of default on such obligations. For European covered bonds, we typically position the CB anchor at the CR assessment plus one notch, and may do so elsewhere where the legal / regulatory framework means authorities are particularly likely to take steps to support covered bonds. In the majority of other cases, the CB anchor is at the same level as the CR assessment.

In exceptional cases we may not add a notch of uplift to a European covered bond, or may reduce the CB anchor below the CR assessment, for example if the covered bond did not fall under a recognised legal regime, or if the covered bond collateral is of low quality and/or insufficient.

We introduced the CR assessment in our updated methodology of March 2015 as a response to the international move towards resolution regimes for banks. Such regimes mean increased likelihood of going concern resolution and, as a consequence, authorities are expected to use powers of write-down (bail-in) that discriminate between different classes of bank debt. Covered bonds are exempted from write-down insofar as they are collateralised, thus should receive favourable treatment compared to unsecured debt.

Moody's EL Model also takes into account various issuer and issuer group-related benefits in addition to the issuer's CB anchor. For instance, the issuer will normally actively manage the cover pool to the benefit of the covered bondholders: this may include replacing defaulted assets with performing assets, or replacing high loan-to-value (LTV) loans with lower LTV loans, particularly if this is required by law. This kind of support from the issuer explains why the issuer's role is more important than that of a simple guarantor.

> Figure 1: Simple average number of notches uplift of covered bond rating over issuer rating



Source: Moody's

[2] For European banks the CR assessment is typically positioned at the issuer's adjusted baseline credit assessment (BCA) plus zero to three notches. For more details see the "Banks" methodology referenced at the end of this article. If the issuer has no CR assessment, we may use the CR assessment of another group entity provided it has a sufficiently robust obligation to provide financial support to the issuer.

[3] In the context of Europe we refer here to the possibility of resolution proceedings and use of the bail-in tool under the EU Bank Resolution and Recovery Directive, adopted 15 April 2014.

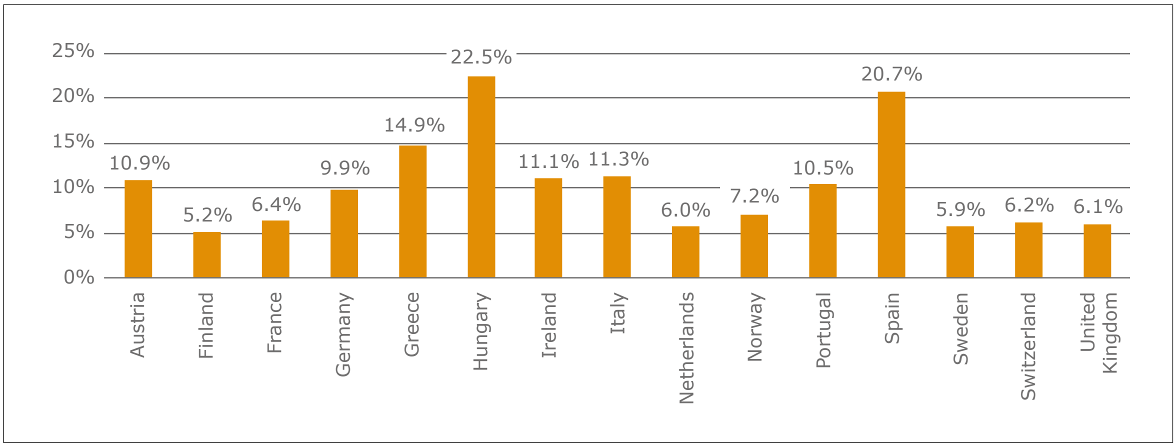
MOODY'S EL MODEL – VALUE OF THE COVER POOL AFTER A CB ANCHOR EVENT

To avoid losses on covered bonds following a CB anchor event, the realisable value of the cover pool, including any over-collateralisation, will need to be sufficient to cover the principal and interest payable on the covered bonds. In our analysis, there are three key factors affecting the value of the cover pool: (1) the credit quality of the collateral; (2) refinancing risk; and (3) interest rate and currency risks. Taken together, refinancing risk and interest rate and currency risks are referred to as market risks.

Credit quality of the collateral in the cover pool

We determine the credit quality of the cover pool by estimating the level of borrower loan losses that will accrue after a CB anchor event in a highly stressed environment. The collateral score measures the level of loss, whereby the lower the collateral score, the stronger the credit quality of the cover pool. Factors that affect the collateral score vary, but for mortgage loans they will normally include (1) the range and distribution of loan-to-value ratios; and (2) the quality of the loan underwriting and, in particular, the calculation of whether the borrower can afford the loan. Factors most relevant for public-sector loans include the credit strength of the public-sector borrowers and the concentration levels of those loans. The credit quality of the cover pool may vary over time, as issuers typically have discretion to add and remove assets, but we monitor this by re-calculating on a quarterly basis the collateral score for most programmes.

> FIGURE 2: SIMPLE AVERAGE COLLATERAL SCORE BY COUNTRY: MORTGAGE BACKED COVERED BONDS



Source: Moody's European Covered Bonds Monitoring Overview, Q3 2014

Refinancing risk in the cover pool

The expected maturity of the assets in the cover pool is generally longer than that of the covered bonds. This mismatch means that, following a CB anchor event, funds may need to be raised against the cover pool to enable timely payment of principal on the covered bonds. Moody's EL Model assumes that when funds must be raised against the cover pool this will be done at a discount to the notional value of the cover pool. The refinancing environment for the assets at this time is likely to be stressed and this is taken into account in the level of discount we build into our credit enhancement assumptions.

The credit enhancement necessary to address refinancing risk is based on three factors:

(1) The level of discount required to sell or refinance the assets (referred to as refinancing margin);

(2) The portion of the cover pool exposed to refinancing risk; and

(3) The average life of the refinancing risk, i.e., the average duration of the refinancing risk for assets in the cover pool at the time of a CB anchor event.

For (2) and (3), we typically assume that the portion of the cover pool exposed to refinancing risk is a minimum of 50% and, at time of a CB anchor event, the average duration of the refinancing risk is a minimum of five years.

For (1), the refinancing margins are set by reference to each jurisdiction and then adjusted for individual programmes. Factors that influence the refinancing margins in our analysis vary, but key factors include (i) on a jurisdiction level, the margins observed for covered bonds in a given market; (ii) on programme and/or jurisdiction level, the mitigants to refinancing risk; and (iii) on a programme level, the collateral quality.

Interest-rate and currency risks in the cover pool

Following a CB anchor event, investors in covered bonds may be exposed to interest rate and currency mismatches. These mismatches result from different interest rates, the duration of these rates, and different currency denominations of cover pool assets compared with the covered bonds.

Under Moody's EL Model, the potential mismatches are estimated by taking into account:

(1) The size of the possible interest rate (or currency) movement over the relevant period, for example looking at the impact of increasing and decreasing interest rates and taking the path that leads to the harshest expected loss on the covered bonds;

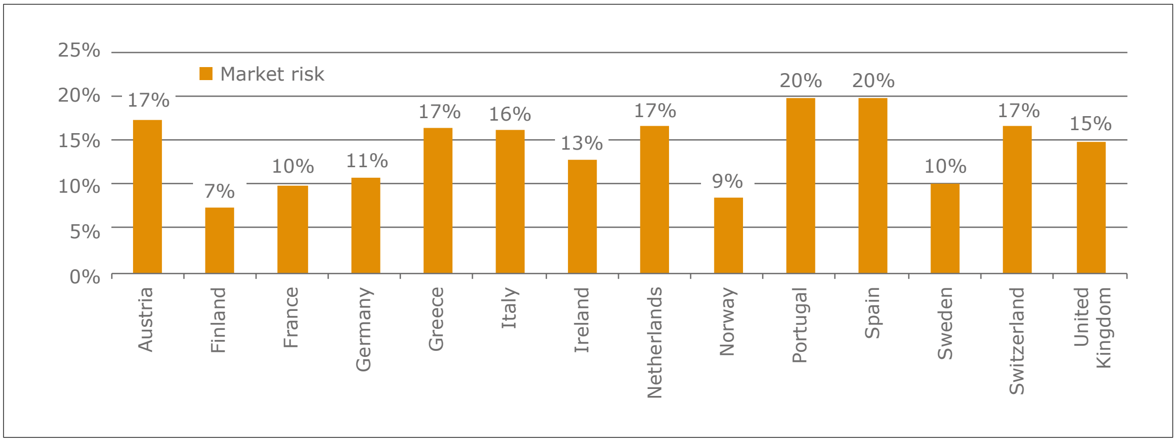
(2) The portion of the assets with interest-rate (or currency) mismatches; and

(3) In the case of interest-rate risk, the average duration of the mismatch based on how quickly the rates or margins on the assets in the cover pool may be adjusted.

Moody's EL Model takes into account whether derivatives hedging is in place at the point of a CB anchor event and the probability of the covered bonds subsequently becoming unhedged. The transaction may become unhedged following either swap counterparty default or issuer payment default due to insufficient proceeds from the cover pool. We assess the risk of counterparty default by applying the principles outlined in our cross sector methodology for assessing swap counterparties in structured finance cash-flow transactions.[4] We assess the risk of payment default by assuming that the risk of the issuer having insufficient cover pool proceeds to pay the swap will be equivalent to the risk that such proceeds will also be insufficient to pay the covered bonds. The risk of non-payment can therefore be estimated by the TPI. However, in no case do we currently assume that derivatives used to hedge interest rate and currency risk completely remove these risks from a covered bond.

[4] "Approach to Assessing Swap Counterparties in Structured Finance Cash Flow Transactions", 16 March 2015, available at Moodys.com.

> FIGURE 3: WEIGHTED AVERAGE MARKET RISK BY COUNTRY: MORTGAGE BACKED COVERED BONDS



Source: Moody's European Covered Bonds Monitoring Overview, Q3 2013

MOODY'S TIMELY PAYMENT INDICATORS (TPIs): LINKAGE AND DE-LINKAGE

TPIs link the issuer, via the CB anchor, to the covered bond rating

Following a CB anchor event, the issuer can no longer be relied on to make timely payments on the bonds and bondholders must therefore rely on external support, liquidity and the legal/contractual framework of the bonds to provide for timely payment. A "timely payment indicator" or "TPI" is Moody's assessment of the likelihood that timely payment would continue to be made to covered bondholders following a CB anchor event. TPIs range from "Very High" to "Very Improbable".

TPIs indicate a ceiling for the rating of a covered bond that limits it to a certain number of notches above the CB anchor. We determine TPIs on a jurisdiction-by-jurisdiction basis as many of the factors we analyse are common to the relevant jurisdiction. TPIs may then be adjusted at the programme level to reflect particular features of a programme. We publish a TPI Table setting out the expected maximum covered bond ratings for different CB anchor/TPI combinations (see Moody's rating methodology report referred to at the end of this chapter). We will normally determine the rating ceiling based on the TPI table. However, for some programmes the actual rating ceiling may be higher or lower, particularly if the issuer has a low investment grade rating, or is rated below investment grade.

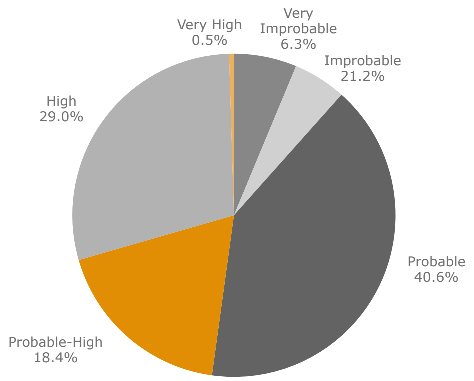
We consider a range of qualitative factors to determine TPIs. The most important of these – and the biggest risk to timely payment for most covered bonds – is the existence of refinancing risk. This risk is highly volatile, which is why our highest ratings cannot be maintained on covered bonds that are subject to material refinancing risk, unless they are also backed by a highly-rated issuer. A key TPI factor relevant to refinancing risk is whether other market participants or the authorities might act to avoid default on the covered bonds despite the issuer failing. Important considerations in this regard are the strength of the covered bond market and regulatory framework.

On a programme level, factors that we consider relevant to TPI levels include (1) continuity of servicing and cash management; (2) the risk that any relevant swaps might be terminated; (3) the risk of acceleration of the covered bonds; (4) over-collateralisation levels; and (5) the issuer's ability to change the programme (in particular to add new assets and enter into new hedging arrangements).

TPI de-linkage

Covered bonds can be TPI de-linked. TPI de-linkage would typically imply a level of de-linkage equivalent to the de-linkage of a securitisation note from the rating of the relevant originator, where the originator has a rating. For a covered bond to achieve TPI de-linkage we would consider whether refinancing risk and the risks around the role of the issuer have been sufficiently neutralised to negate their impact on the covered bonds. One method of removing refinancing risk would be to replace a hard or soft bullet principal repayment on the bonds with a pass-through or conditional pass-through from asset cash-flows.

> FIGURE 4: TPI DISTRIBUTION



Source: Moody's European Covered Bonds Monitoring Overview, Q3 2014.

References (all available at Moodys.com):

> Moody's EMEA Covered Bond Monitoring Overview: Q3 2014 (updated quarterly).

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4.5 STANDARD & POOR'S COVERED BOND RATING METHODOLOGY

By Roberto Paciotti and Antonio Farina, Standard & Poor's

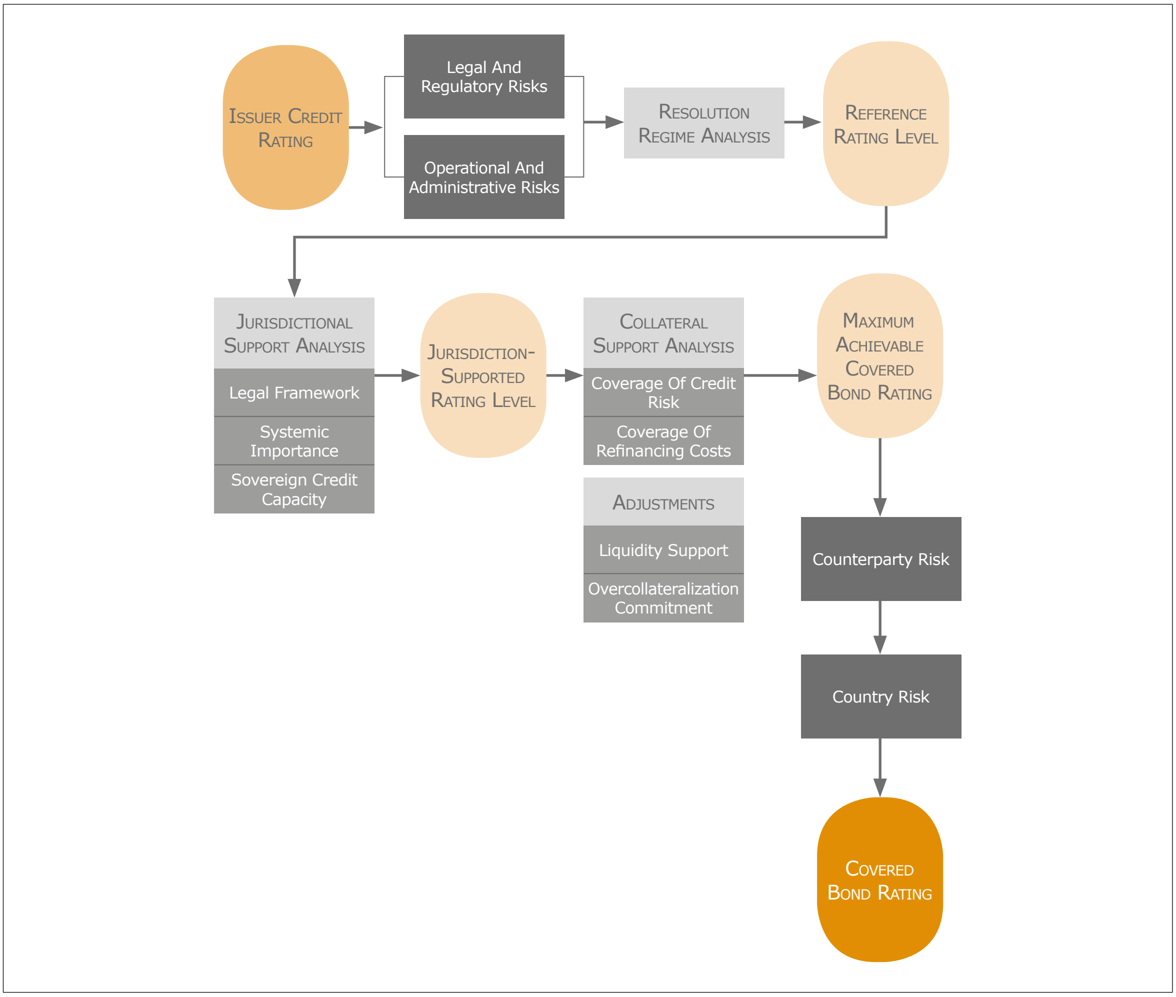
Standard & Poor's Ratings Services' covered bonds rating approach is explained in the criteria "Covered Bond Ratings Framework: Methodology and Assumptions," published on 30 June 2015, and "Covered Bonds Criteria," published on 9 December 2014. These articles are available on the Global Credit Portal and at www.standardandpoors.com/coveredbonds. While this paper summarises certain covered bond criteria and rating methodologies, these articles remain Standard & Poor's definitive treatment of the subject.

Standard & Poor's organises the analytical process for rating covered bonds into four stages (see Figure 1):

1. Performing an initial analysis of legal and regulatory risks and operational and administrative risks specific to the issuing bank (issuer) which contribute to our assessment of whether the covered bond programme is sufficiently "distanced" from the credit risk of the issuer so as to permit the ratings on the programme (and on the covered bonds) to be higher than the issuer's own credit rating (ICR).
2. Assessing the starting point for the analysis of the potential uplift above the ICR, based on relevant resolution regimes.
3. Determining the potential bond rating on the basis of the jurisdictional support and of the cover-pool specific factors.
4. Combining the results of the above and incorporating any additional factors, such as counterparty risk and country risk, to assign the final covered bond rating.

The outcome of Standard & Poor's rating analysis is a rating on the covered bond programme and the bonds issued under the programme. The quarterly publication "Global Covered Bond Characteristics" gives an overview on the key rating factors including credit and cash-flow indicators of the programmes that Standard & Poor's rates (see www.standardandpoors.com/coveredbonds).

> FIGURE 1: COVERED BOND RATINGS FRAMEWORK


Issuer Credit Rating
Legal And Regulatory Risks
Operational And Administrative Risks
Resolution Regime Analysis
Reference Rating Level
Jurisdictional Support Analysis
Legal Framework
Systemic Importance
Sovereign Credit Capacity
Jurisdiction-Supported Rating Level
Collateral Support Analysis
Coverage Of Credit Risk
Coverage Of Refinancing Costs
Adjustments
Liquidity Support
Overcollateralization Commitment
Maximum Achievable Covered Bond Rating
Counterparty Risk
Country Risk
Covered Bond Rating

Source: Standard & Poor's.

COVERED BOND ISSUER-SPECIFIC FACTORS

We conduct our initial analysis of the covered bond ratings with the primary aim of determining whether the covered bond rating may exceed the ICR. Due to the dual-recourse nature of covered bonds, the covered bond rating is typically no lower than the relevant rating on the covered bond issuer.

Legal and regulatory risks

The assessment of legal and regulatory risks focuses primarily on the degree to which a covered bond programme isolates the cover pool assets from the bankruptcy or insolvency risk of the issuer. If the asset isolation analysis concludes that covered bonds are not likely to be affected by the bankruptcy or insolvency of the issuer, then we may assign a rating to the covered bonds that is higher than the rating on the issuer.

Standard & Poor's typically reviews the following legal aspects when assigning a rating to a covered bond programme:

- The nature of the segregation of the assets and cash flows if the issuer becomes insolvent;
- Whether there is any acceleration of payments to noteholders if the issuer becomes insolvent – whether payments of interest and principal will continue in accordance with the original terms of the covered bonds;
- Whether there is any payment moratorium or forced restructuring of the programme or the covered bonds if the issuer becomes insolvent; whether there are any limits to overcollateralisation levels, i.e., if a programme may overcollateralise its covered bonds above the minimum limit defined under the legislation or the programme documents, and whether this additional overcollateralisation is available to the covered bondholders, notwithstanding any issuer insolvency;
- The treatment of any hedging agreements if the issuer becomes insolvent;
- Whether the programme can access funding if the issuer becomes insolvent; and
- The management of the cover pool both before and after the issuer becomes insolvent.

Operational and administrative risks

The analysis of operational and administrative risks focuses on individual transaction parties to assess whether they are capable of managing a covered bond programme while bonds remain outstanding.

The primary transaction party in a covered bond programme is the issuer which is why we perform a risk analysis on its origination, underwriting, and servicing operations.

RESOLUTION REGIME ANALYSIS

Our criteria recognise that resolution regimes like the EU's Bank Recovery And Resolution Directive (BRRD) can increase the likelihood that an issuer can continue to service its covered bonds despite its own insolvency and defaulting on its senior unsecured obligations. Should an issuer become insolvent and thereupon be subject to a resolution regime that excludes covered bonds from the issuer's insolvency proceedings, our assessment of the likelihood that the issuer would still service the programme's covered bonds without receiving support from the jurisdiction or reverting to a sale of programme assets (in other words, that the programme assets generate sufficient cashflow to service outstanding bonds and meet servicing and related administrative costs) determines the reference rating level (RRL).

In countries subject to the BRRD, or having similar resolution regimes, depending on the systemic importance of the covered bond programmes to that country, our criteria provides that we may add one or two notches above the ICR, after adjustments to remove any uplift allocated to reflect any extraordinary support provided to the issuer from the relevant government. This RRL reflects our view of the increased likelihood that the issuer will service its covered bonds even if insolvent. For countries without resolution regimes like the BRRD our criteria directs that we set the RRL at a level equal to the issuer's ICR.

JURISDICTIONAL SUPPORT ANALYSIS

If the issuer becomes insolvent, fails to return to being a going concern following resolution proceedings and is unable or unwilling to service the programme, the programme administrator would turn to sources other than the issuer to meet payments due and mitigate the refinancing risk. In our opinion, jurisdictional support would likely be forthcoming in countries with a robust covered bond statutory and regulatory framework and where covered bonds play a systemically important role in government policy.

The criteria reference the support of a "jurisdiction" rather than a "government." That is because we believe support may come through direct government intervention such as from a central bank; indirect intervention such as a government's use of private-sector mechanisms to provide support; or through trustees, administrators, or other parties acting to protect covered bonds according to specific laws or other requirements.

Under Standard & Poor's criteria, we consider the likelihood for the provision of governmental support when the cost of a failed covered bond programme to an economy and financial system would be considered greater than the cost of providing support. To assess this, we analyse: 1.) the strength of the legal framework, 2.) the systemic importance of the covered bonds in the country, and 3.) the credit capacity of the sovereign to support the covered bonds (see Figure 2). Based on these specific factors, the criteria establish a four-point classification of jurisdictional support of "very strong," "strong," "moderate," and "weak". Depending on our assessment, the criteria provide for potential rating uplift of up to three notches above the covered bond's RRL. This rating uplift reflects the strength of jurisdictional support that we believe might be forthcoming.

This jurisdictional-supported rating level (JRL) is our assessment of the creditworthiness of a covered bond programme once we have taken into consideration jurisdictional support for the programme, but before giving benefit to the programme administrator's ability to access other refinancing sources.

> Figure 2: Assessing jurisdictional support

Assessments	Factors				Jurisdictional support uplift
	Legal framework	Systemic importance	Sovereign credit capacity		
Very Strong	Robust legal framework that establishes a minimum level of overcollateralization, and sets out a dedicated public supervision and eligibility criteria for high-quality cover pool assets. The framework rests solely on the spercific covered bond legislation.	Covered bonds play a material role as a funding source for the financial system, with material economic impact.	Sovereign has sufficient financial resources to support covered bonds, not subject to third-party conditions, and its foreign currency rating is 'BBB-' or above.	→	Very strong: up to three notches of uplift above the RRL
Strong	Robust legal framework that establishes a minimum level of overcollateralization and provides eligibility criteria that allow only high-quality assets in the cover pool.	Covered bonds play an important role as a funding source for the financial system, with important economic impact.	Sovereign has sufficient financial resources to support covered bonds (subject to third-party conditions) and its foreign currency rating is 'BBB-' or above.	→	Strong: up to two notches of uplift above the RRL
Moderate	Same as for strong.	Covered bonds play a modest role as a funding source for the financial system, with modest economic impact.	Sovereign has sufficient financial resources to support covered bonds (subject or not to third-party conditions) and its foreign currency rating is 'BB-' or above.	→	Moderate: up to one notch of uplift above the RRL
Weak	Meets minimum legal provisions but does not meet all of the characteristics of a moderate legal framework.	Does not meet the characteristics of at least moderate support.	Does not meet the characteristics of at least moderate support.	→	Weak: no uplift above the RRL

Source: Standard & Poor's.

COLLATERAL SUPPORT ANALYSIS

We then consider to what extent overcollateralisation enhances the creditworthiness of a covered bond issuance by allowing the programme cover pool to raise funds from a broader range of investors and so address its refinancing needs. This overcollateralisation may cover the credit risk only, that is the expected losses incurred by the cover pool in a stressed scenario, or such credit risk plus the refinancing costs, that is, the additional collateral required to raise funds against its assets to repay maturing covered bonds (due to the mismatch between assets and liabilities). We refer to this as "collateral-based uplift".

Our analysis starts with the calculation under our criteria of the credit enhancement for each notch of collateral-based uplift to meet a specific rating level for the programme. This is a function of the maximum number of notches of uplift for collateral, i.e., the maximum collateral-based uplift, and the "target credit enhancement" (TCE), which is the level of overcollateralisation that is commensurate with this maximum collateral-based uplift (see Figure 3).

We then compare the required credit enhancement to the available credit enhancement to calculate the "potential collateral-based uplift." We adjust this uplift for liquidity risk and uncommitted overcollateralisation to arrive at the maximum achievable covered bond rating.

The "maximum collateral-based uplift" for a given covered bond programme depends on our view about the presence of active secondary markets for the assets in the cover pool. In particular, we may allow up to four notches of collateral-based uplift above the JRL for overcollateralisation covering credit risk and refinancing costs where we believe active secondary markets exist to enable the covered bond to raise funds against its assets. Alternatively, we may allow up to two notches of rating uplift above the covered bond's JRL for overcollateralisation to cover credit risk only, in jurisdictions that we believe do not have a sufficiently active secondary market to enable the covered bond to raise funds against its assets.

Figure 3 below shows the credit enhancement necessary to achieve each additional notch of uplift above the RRL, before adjusting for liquidity risk and uncommitted overcollateralisation.

> Figure 3: Credit enhancement for uplift above the RRL

Assigned jurisdictional uplift	Notches of uplift above the issuer's RRL						
	1	2	3	4	5	6	7
No jurisdictional uplift	Credit risk at RRL plus 1 rating category	Credit risk at RRL plus 2 rating categories	Credit risk at 'AAA' and 75% of the refinancing costs	Credit risk at 'AAA' and 100% of the refinancing costs	N/A		
1 notch of jurisdictional uplift	Legal minimum	Credit risk at RRL plus 2 rating categories	Credit risk at 'AAA' and 50% of the refinancing costs	Credit risk at 'AAA' and 75% of the refinancing costs	Credit risk at 'AAA' and 100% of the refinancing costs	N/A	
2 notches of jurisdictional uplift	Legal minimum	Legal minimum	Credit risk at 'AAA' and 25% of the refinancing costs	Credit risk at 'AAA' and 50% of the refinancing costs	Credit risk at 'AAA' and 75% of the refinancing costs	Credit risk at 'AAA' and 100% of the refinancing costs	N/A
3 notches of jurisdictional uplift	Legal minimum	Legal minimum	Legal minimum	Credit risk at 'AAA' and 25% of the refinancing costs	Credit risk at 'AAA' and 50% of the refinancing costs	Credit risk at 'AAA' and 75% of the refinancing costs	Credit risk at 'AAA' and 100% of the refinancing costs

Color coding	Notches of uplift allocated on the basis of regulatory minimum overcollateralization, or, in order to achieve a 'AAA' rating on the covered bond, the higher of regulatory minimum and credit risk at a 'AAA' level of stress	Notches of uplift allocated on the basis of coverage of credit risk only	Notches of uplift allocated on the basis of coverage of 'AAA' credit risk and refinancing costs

Note: This applies to programms with no adjustments for liquidity or uncommitted overcollateralization and assuming that a secondary market for the cover pool assests exists to cover refinancing costs. N/A—Not applicable.

Source: Standard & Poor's.

Credit risk analysis

Standard & Poor's analyses the underlying cover pools to form a view on the expected stressed asset performance using jurisdiction- and asset-specific assumptions. These cover pool assets typically contain residential mortgage loans, public sector bonds and loans, or some other form of high credit-quality collateral. The credit analysis also incorporates issuer-specific aspects such as the impact of its underwriting policies or its collateral management.

Refinancing risk analysis

Standard & Poor's models refinancing risk by applying an additional asset dependent "spread shock" when calculating a stressed net-present value of the cash flows of the assets to be sold. In its calculation of the target credit enhancement, we also incorporate asset default stresses (including any amounts for counterparty risks such as commingling risk that are not structurally mitigated) and any interest and currency stresses that are not appropriately hedged.

After comparing the required credit enhancement to the available credit enhancement to calculate the "potential collateral-based uplift", we adjust this uplift for liquidity risk and uncommitted overcollateralisation to arrive at the maximum achievable covered bond rating.

We reduce the collateral-based uplift by one notch if the programme does not benefit from at least six months of liquidity. This adjustment reflects our view that accessing the market to raise funds against the assets may take time, during which the bonds may be exposed to payment disruption.

Standard & Poor's consider the actual forms of commitment on overcollateralisation levels, reducing the potential collateral-based uplift when we believe there is a risk that the overcollateralisation level, on which we base our analysis, may decrease over time.

EXTERNAL FACTORS

Finally, in addition to the analysis of the risks outlined above, Standard & Poor's reviews any counterparty or country risk exposures. These risks might constrain the achievable covered bond rating even if sufficient overcollateralisation to cover other risks exists. Therefore, we analyse whether these risks would limit the maximum achievable covered bond rating as determined based on the previous steps of the analysis.

Counterparty risks

If a programme benefits from interest rate or currency hedges to mitigate interest rate or currency mismatches, Standard & Poor's reviews the underlying agreements to assess whether they conform with its counterparty criteria. Deviations can result in either incorporating the unhedged risks into the sizing of the target credit enhancement or capping the maximum achievable covered bond rating.

In its analysis, Standard & Poor's also assesses how other counterparties that provide support to the transaction could affect the rating. This also includes whether account bank risk is adequately mitigated or whether, if the issuer becomes insolvent, cash flows could become commingled and ultimately lost. The loss of cash flows, in our view, must also be seen as an asset default related risk. If not mitigated in accordance with our counterparty criteria, we typically incorporate any such risk in our analysis of the cover pool's payment structure and cash flow mechanics, alternatively, the covered bond rating will be further constrained.

Country risks

We also analyse the underlying assets' and transaction's sensitivity to country risk and the asset portfolio's diversification by jurisdiction. For covered bonds exposed to refinancing risk and issued from within the European Monetary Union (EMU), we assign up to four notches of uplift above the sovereign rating.

We determine the maximum rating differential between sovereign and covered bond ratings based on the sovereign rating level and the covered bond programme's country-risk exposure (see "Methodology and Assumptions for Ratings Above the Sovereign – Single-Jurisdiction Structured Finance," published on 19 September 2014). This assessment caps any potential further uplift typically available under our criteria for rating covered bonds.

DELINKING COVERED BOND RATINGS

A covered bond rating is delinked from the RRL of the issuing bank when the programme structurally has no mismatch between assets and liabilities and the covered bond's overcollateralisation is legally or contractually committed. In this case, we determine the rating according to whether the available credit enhancement is sufficient to pass our stress scenarios. In other words, we do not cap it as a function of the issuer's RRL or a predetermined level of rating uplift.

The assignment of outlooks

Under its criteria for rating covered bonds, Standard & Poor's assigns an outlook to all covered bond ratings that are linked to the issuer's creditworthiness. These outlooks provide a view of a programme's potential for a rating change and its direction over the intermediate term (see "Use of CreditWatch and Outlooks," published on 14 September 2009). The covered bond outlooks take into account Standard & Poor's views on the outlook on the issuer, the level of ratings uplift achieved, as well as potential rating changes due to the performance of the collateral.

4.6 SCOPE RATINGS COVERED BOND RATING METHODOLOGY

By Karlo Fuchs and Guillaume Jolivet, Scope Ratings

Scope Ratings' covered bond rating methodology is explained in detail in "Rating Methodology: Covered Bonds" available at www.scoperatings.com/methodologies/list.

SUMMARY

Scope's covered bond rating methodology (the methodology) reflects post-crisis realities, including the new regulatory and supervisory framework for banks created after the crisis, such as bail-in and stronger prudential metrics. These have significant implications for covered bond ratings. The former base case for a covered bond analysis of an insolvent issuer with the cover pool as the sole source of repayment has now become extremely remote. As a result, the covered bond rating reflects:

> the importance of the Issuer's Credit-Strength Rating (ICSR) as the fundamental anchor for the covered bond analysis;

> the combination of the legal and resolution framework, which establishes important supporting elements for the covered bond rating;

> the benefit of the cover pool representing the second recourse coming into effect only after a chain of events affecting the issuer. The benefit of the cover pool is limited, but provides additional security and stability to the rating.

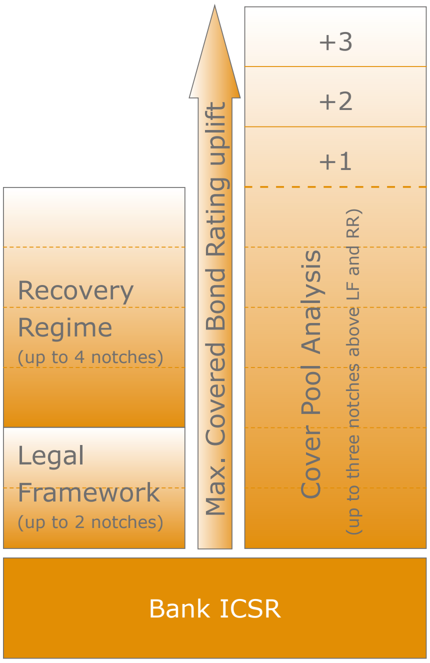
Scope's bank ICSR represents a credit opinion on a bank's ability to meet its contractual financial commitments on a timely basis, and in full, as a going concern. It is mostly regulatory action which leads to default-like situations for banks. Therefore, Scope's bank ratings reflect the probability of regulatory action leading to default-like events.

Once a regulated bank has passed the resolution trigger – the point of non-viability – and the issuer is subject to regulatory intervention, unsecured bank investors are directly exposed to the risk of a potential bail-in. Covered bonds, however, are one of the few bank liabilities not subject to bail-in, and are expected to continue to perform and benefit from the continuation of the issuer. The need to rely on the second recourse (cover pool) only arises when: i) available regulatory capital is fully depleted; ii) significant amounts of bail-in-able debt converted into capital or written down are insufficient to ensure continuation of the issuer, and iii) the restructured or resolved bank becomes insolvent. The rating of a covered bond must therefore reflect this high degree of protection, unique within the liability structure of banks.

Scope's covered bond rating methodology reflects the crucial importance of the legal and regulatory framework to assess a covered bond's credit risk. As a result, before considering the benefit of the cover pool, Scope considers that a covered bond issued by a resolvable bank can present credit risk enhancement up to six notches above the ICSR of the bank.

Scope's analysis also takes into account the benefits of a second recourse to the cover pool. However, the chain of events leading to recourse to the cover pool is extremely improbable under a post-crisis resolution regime. Scope nevertheless recognises that credit quality of cover pools differs significantly from one issuer and covered bond type to another. In addition, the management of risks varies according to the issuer's degree of management discretion. Scope therefore performs a thorough analysis of the cover pool as it provides key information about the robustness of the covered bond's second recourse as well as the magnitude of the expected loss for the instrument. Scope believes the cover pool can further enhance the credit risk of the instrument by up to three notches above the uplift provided by the regulatory framework applicable to the issuer and its covered bonds.

> FIGURE 1: BUILDING BLOCKS OF SCOPE'S COVERED BOND METHODOLOGY



Source: Scope Ratings

Covered bond ratings are in general linked to the bank's ICSR. The exceptions are cases where the influence of the issuer on a covered bond risk and refinancing structure is mitigated by features similar to a structured finance transaction. For example, covered bonds that become pass-through after meeting certain criteria.

Covered bond ratings for highly rated banks are driven primarily by the fundamental benefits of the regulatory framework applicable to banks and their covered bonds. The supporting benefit of the cover pool only becomes relevant when the credit quality and the bank ratings start to shift downwards. As a result, prudent management of the covered bond programme and the extent to which the remaining credit, market and refinancing risks are mitigated, primarily impact the ratings of covered bonds issued by lower rated banks.

LEGAL FRAMEWORK AND RESOLUTION REGIME ASSESSMENT

The legal framework analysis in our methodology covers aspects relevant upon insolvency of the issuer and provides a credit differentiation based on the clarity of provisions supporting the situation where the cover pool is the sole source of repayment for a covered bond. The resolution regime analysis addresses the situation prior to insolvency of the issuer. It reflects the ability of statutory provisions to avoid negative repercussions on the covered bond in a resolution scenario. Furthermore, systemic importance might mobilise regulators, supervisors or the private sector to be supportive and proactive in avoiding uncertainty during resolution for covered bond investors. The resolution regime assessment identifies the importance of the relevant covered bond type in each country to understand the incentives for market-led solutions, and whether the track record of proactive and transparent use of available resolution and restructuring tools is likely to impact covered bonds or not.

Legal framework analysis

In the legal framework assessment we identify whether a smooth transition of the covered bond structure away from the insolvent issuer is possible. The transition should allow maintenance of the cover pool and for an ongoing full and timely payment of outstanding covered bonds upon restructuring or insolvency. Programme enhancements, in particular overcollateralisation, should remain available, valid and enforceable to other creditors, and neither a regulatory action nor an issuer event of default should impact the ability to manage the covered bond structure in the best interests of investors. The framework should provide for a credit, market and liquidity risk management prior the insolvency and allow proactive liquidity management after the insolvency to facilitate timely payment to covered bond holders. We seek to understand how a potential conflict of interest between covered bond holders and other debtors is resolved in a regulatory action or insolvency. Lastly, we analyse whether an independent and regular oversight of the programme structure (asset composition/ structural risk) by either supervisor or a special trustee is performed.

If the elements mentioned above only partially apply, the credit differentiation will be limited. For instance, if covered bonds were to accelerate upon insolvency of the issuer, either because of contractual or statutory provisions, the maximum uplift from the legal framework analysis for the covered bond rating only warrants a limited uplift of possibly only one notch. Similarly, absence of dedicated covered bond oversight will likely prevent it receiving the highest credit differentiation. The limitation reflects that some of the main assumptions for a covered bond are not met, i.e. uninterrupted payment of bonds after insolvency or special oversight.

Regulatory definitions of covered bonds address some aspects relevant for the rating analysis. The legal framework assessment does not follow regulatory designations mechanistically, but focuses on aspects relevant to the credit differentiation.

Resolution regime analysis

We believe that for covered bonds issued by banks operating in a resolution regime similar to the one outlined in the Bank Recovery and Resolution Directive (BRRD), full reliance on the cover pool will become extremely unlikely compared to the pre-resolution regime. When determining the resolution regime analysis driven credit differentiation between covered bonds and the bank's ICSR, we identify factors that inform us of the likelihood a regulatory intervention on the issuer will not impact a covered bond's credit quality:

- whether statutory provisions in resolution regimes address the going concern status of covered bonds upon a regulatory intervention on the issuer;
- whether the issuer's liability structure, or level of bailinable debt, allows regulators to use available resolution tools to restructure the issuer to maintain the covered bond program as a going concern, and the level of bailinable debt provides a loss-absorption cushion that protects covered bonds;
- whether covered bonds are a systemically important funding tool used by the majority of banks in the country;
- whether this specific covered bond type is the main tool to refinance a specific asset type that is important for the economy and the product has a significant share of domestic investors; and
- whether there is an active domestic stakeholder community (regulators, issuers and investors) proactively monitoring market developments and maintaining confidence in the product and encouraging an improvement in relevant regulations. This encompasses an assessment of the clarity and predictability of relevant statutory provisions and their interpretation and the track record of relevant authorities.

We believe these aspects are important to understand the ability to maintain covered bonds as a going concern funding instrument – even during the resolution process. If we believe regulatory action regarding the issuer is unlikely to impact a covered bond as a going concern instrument, we translate this reduced likelihood of default by assigning up to four notches of uplift for the availability of such a supportive resolution framework.

If elements from the above apply only partially, benefits of the resolution regime will be limited, reflecting the increased likelihood of the covered bonds winding down and the cover pool becoming the sole source of repayment for the covered bonds.

Cover pool analysis

Covered bonds issued by high investment-grade-rated resolvable banks can exhibit a credit quality commensurate with AAA level, because of the covered bond status in the bailin, regardless of the overcollateralisation level in their cover pool. The use of the cover pool to fulfil the payment obligations under the covered bond only becomes necessary when a resolution has failed and the issuer has defaulted.

The cover pool analysis informs us how specific features of the covered bond structure, as well as other country-specific aspects, may affect the probability of default and the loss given default in this scenario. It also provides information on the resulting rating sensitivity.

A cover pool with a strong credit profile may further enhance the credit differentiation of the covered bond over and above the credit differentiation established in the legal and resolution framework analysis. In general, we believe the covered pool can support an additional credit differentiation to the banks ICSR by up to three notches.

Asset analysis

In our quantitative cover pool analysis, we develop a detailed understanding of the credit and cash flow risks a covered bond is exposed to. Our goal is to take account of the issuer-specific performance of the relevant assets present in the cover pool. Our base case credit analysis reflects the actual credit performance of the cover pool assets originated by the issuer. It may also reflect generic, country- and asset-specific credit and cash flow assumptions. To identify the level of credit differentiation a cover pool can support, we increase the severity of stresses applied to the cover pool in accordance with the distance between the covered bond rating and the ICSR.

The higher the benefit of the cover pool to the covered bond rating, the more resilient the cover pool's credit performance has to be in case of stress.

Cash flow analysis

In our cash flow modelling, we determine the scheduled cash flows based on the cover pool assets, outstanding covered bonds and related derivatives, while also taking available overcollateralisation into account. We then apply stresses to the asset and market, and in particular, refinancing risks. By considering various levels of overcollateralisation, we gain insight into the ability of the cover pool to support further credit differentiation. We complement our static cash flow analysis with forward-looking views on the potential evolution of risk factors.

The assessment of repayment risk is important for covered bond ratings, as this is generally the highest risk covered bonds can be exposed to. Structural features may mitigate, but in most cases will not fully eliminate, refinancing risk. Our assessment of the extent to which refinancing risk impacts the credit quality of covered bonds also reflects their role in the financial system. We reflect in the quantitative assessment the options available to generate liquidity to repay maturing covered bonds. Generally, we recognise that proceeds from asset sales will be higher in countries where the product is systemically important and where there is a well-established covered bond market compared to countries where covered bonds are only used occasionally.

Availability of overcollateralisation

Overcollateralisation is the variable managed most actively by issuers to support and maintain covered bond ratings over and above the bank ICSR. The assessment of an issuer's ability and willingness to provide such funding is essential and must be reflected in the rating analysis. In the absence of contractual commitments, we assume that the lower its ICSR falls, the more likely an issuer will exercise management discretion to provide adequate overcollateralisation.

If the issuer has an ICSR of at least BBB our analysis considers the currently available overcollateralisation. If the rating is below BBB, our decision to take the currently available overcollateralisation into account depends on whether the issuer engages in sufficiently robust capital market communication on overcollateralisation in line with expectations. We adjust the level of overcollateralisation downward if there are no such statements. The adjustment reflects the past volatility and our forward-looking view on expected overcollateralisation levels. We only take the legal minimum for issuers rated in the BB category and below into account if there are no public contractual commitments.

Counterparty risk

Our rating methodology for counterparty risk in structured finance transactions is the basis for assessing the dependency on key counterparties and how they could impact the cover pool analysis. The guiding principles are the materiality of counterparty risk (excessive, material or immaterial), differentiation between financial and operational risk exposure, and analysis of risk remedies in the specific context of the covered bond transactions.

The covered bond counterparty analysis informs us whether the performance and creditworthiness of a covered bond could be impacted by an inadequate credit strength of external counterparties. This could constrain the potential benefit from the cover pool analysis. An effective replacement framework or other structural risk mitigating mechanisms for key agents can typically avoid a negative impact. Ineffective remedies result in quantification of counterparty risk which can ultimately constrain the benefit of the cover pool analysis for the covered bond rating. This is especially relevant for counterparty obligations that are very significant or bespoke, potentially resulting in an "excessive" classification as per our counterparty criteria. An excessive counterparty exposure may result in a direct link of the cover pool benefit to the providing counterparty.

Sovereign risk

Scope does not mechanistically limit the maximum rating achievable by a covered bond to the sovereign credit assessment of the issuer's country, or the country cover pool assets are originated in. Imposing a mechanistic rating cap, particularly in eurozone countries does not, in our view, allow for an adequate relative ranking of covered bonds' credit quality.

Macroeconomic factors play an important role in Scope's rating analysis, however. We analyse the impact of sovereign and macroeconomic developments to ensure Scope's view on the credit fundamentals of the relevant home sovereign is included in the stresses that support covered bond ratings. The weight given to these factors may differ in both the covered bond and the bank analysis, as the cover pool composition and risk profile may exhibit different risk characteristics than the rest of the balance sheet. Sovereign considerations will consequently not be of uniform significance among issuers. The relative significance of such considerations may vary between different cover pools of the same issuer as composition of cover pool assets varies as well.

Regular surveillance

Scope's covered bond ratings are subject to an ongoing, usually quarterly surveillance. We monitor the development of the banks ICSR and covered bond specific risks. Observed changes to the cover pool and the cash flow structure are regularly assessed against the level and availability of overcollateralisation. Factors relevant to the legal and resolution framework assessment are also monitored. We will regularly publish key covered bond credit risk factors and their development.

Related research:

> "Rating Methodology: Covered bonds", July 2015;

> "Bank Rating Methodology", May 2015;

> "Rating Methodology for Counterparty Risk in Structured Finance Transactions, August 2015".

The above research is available at www.scoperatings.com/methodologies/list.

CHAPTER 5 - COVERED BOND STATISTICS

5.1 INTRODUCTION AND METHODOLOGY

By Florian Eichert, Crédit Agricole CIB and ECBC Statistics & Data Working Group Chairman

The ECBC Statistics and Data Working Group has been collecting statistics on the outstanding volume and annual gross supply of covered bonds at year end for 12 years now. From the start its aim has been to provide a complete set of numbers that can serve as guidance for interested parties from issuers and investors to regulators.

The collection of statistics is a significant undertaking each year which is only possible thanks to the cooperation of the Working Group members, covered bond issuers and banking associations. One representative per country (the list of country representatives can be found on the ECBC website) undertakes the initial data collection by approaching each issuer separately in most countries. These figures are then cross checked on the basis of publicly available data by a small number of Working Group members. The 2014 numbers were cross checked by Anne Caris and Rondeep Barua from Bank of America / Merrill Lynch, Cristina Costa and Jean-David Cirotteau from Société Générale, Gordon Kerr from DBRS, Agustin Martin and Aaron Baker from BBVA, Johannes Rudolph from ING Bank, Alexandra Schadow from LBBW, Michael Weigerding from Commerzbank as well as myself.

GENERAL REMARKS ON THE 2014 STATISTICS

The aim of the ECBC statistics is to paint as realistic a picture of the actual market and picture relevant trends as accurately as possible. After the methodology changes in 2012 (more realistic public vs. private placement buckets) and 2013 (introduction of the number of programmes) we have kept the framework unchanged in 2014.

We have tried in the past and will continue to try to improve the quality of the data even for previous years. It is always possible that we miss a bond or still include a bond that has been repaid early (just think of retained covered bonds). Wherever we realise that there was a mistake in last year's data we amend the numbers. As a result of this, there are some slight differences in the numbers for 2013 compared to what was published last year. In our view, these adjustments are perfectly normal and we would rather adjust historic data to reflect a more realistic picture than mechanically hold on to data that was once published but proven incorrect wherever we have sufficient information to make the change.

Before going into the actual statistics, we want to make some general remarks about the figures which are necessary to interpret them correctly:

> Covered bonds are divided into those denominated in euro, those in domestic currency (if not the euro), and those in a currency other than the euro and the domestic currency. The exchange rate used to convert all outstanding volumes at the end of the year in non-EUR-denominated bonds is the end-of-year rate published by the European Central Bank (ECB).

> For the purpose of counting the number of issuers and of new issuers the following applies. Issuers are entities with at least one outstanding covered bond at year-end. Issuers with multiple programmes still only count as one. The only exception to this rule is French covered bonds. In the case of France, the actual issuer is a specialised bank rather than the mother company. As a result, one mother company with two covered bond programmes also counts as two issuers as the issuance actually comes from two separate legal entities. New issuers are entities with at least one outstanding covered bond at year-end, but with no outstanding covered bond at the prior year-end.

> Spain: Spain's covered bond statistics are based on the data provided by Spain's AIAF (Asociación de Intermediarios de Activos Financieros). We have complemented this with USD denominated Cédulas issued under Reg/S or 144a documentation that are not listed in the AIAF as well as registered unlisted covered bonds from the ECBC Covered Bond Label Database. The breakdown into public and private placements in Spain is entirely based on non-AIAF sources as the AIAF database does not systematically include this criterion. Up to 2011, the number of issuers provided by AIAF included the new financial

institutions established as part of the restructuring of the Spanish banking sector as well as all the former financial institutions with outstanding covered bonds at the end of 2011 – even if as a consequence of the aforementioned restructuring they were integrated into a new institution. Because of this the number of issuers had been going up rather than down which is what one would have expected. When adjusting for the merger activity, the number of issuers at the end of 2011 was 42 rather than 64. For this year as well as 2012, we have changed the way we calculate the number of Spanish issuers to only include those that are separate legal entities and disregard any previous entities that have by now been merged.

> Canada: Covered bonds backed by mortgages insured against borrower default by the Canada Mortgage and Housing Corporation are classed as mortgage covered bonds.

> Sweden: Sweden's covered bond statistics exclude retained transactions used for the purpose of accessing central bank liquidity, and include only converted bostadsobligationer (mortgage bonds) and säkerställda obligationer (covered bonds).

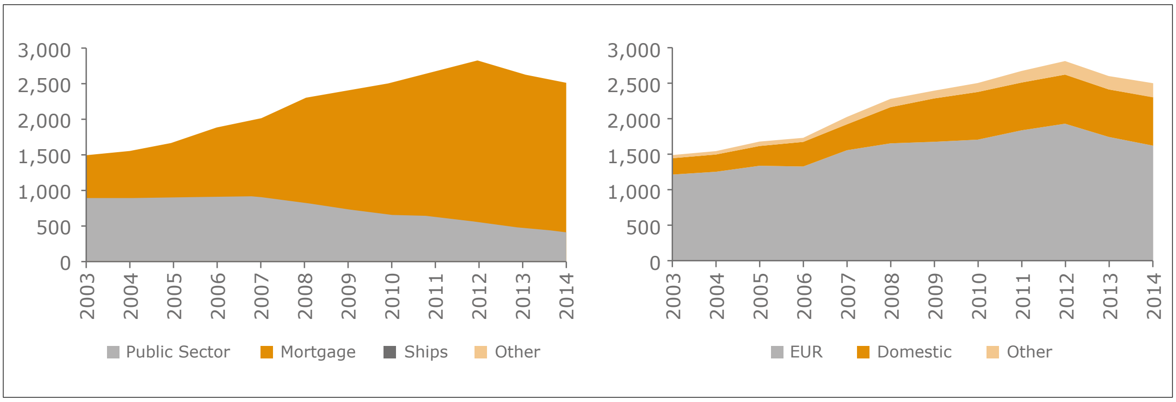
EVOLUTION OUTSTANDING VOLUMES 2014

After a continuous increase in outstanding volumes between 2003 and 2012 covered bond markets contracted quite sharply for the first time in 2013 (-EUR211bn or 8%). In 2014 this trend has continued; however, at a much slower pace. Overall outstanding volumes fell by EUR95bn or 4% to EUR25tn with 15 out of the 29 countries recording contracting volumes, 13 countries still growing and one country with unchanged volumes.

The biggest drop in volumes came from Spain as well as Germany where outstanding volumes contracted by EUR57bn (-16%) and EUR50bn (-11%). Other than last year in Spain the drop in volumes came predominantly from publicly placed deals, not from retained ones. In Germany we are still talking about public sector backed covered bonds being behind the vast majority of the fall in volumes. We will still have this factor in the 2015 figures as the last assets from the savings banks finance group with the old maintenance obligations mature that year.

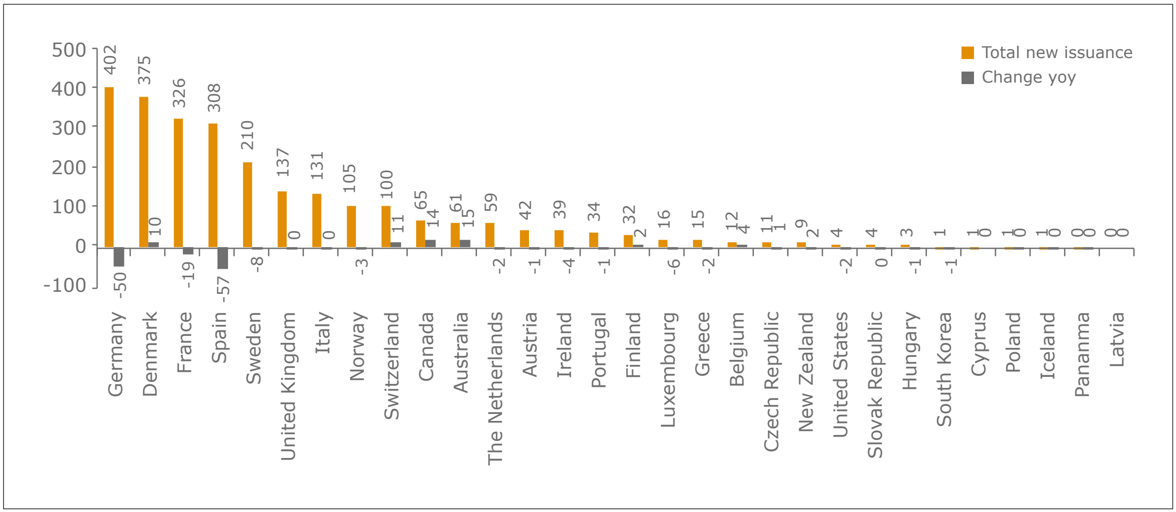
As mentioned above, there were still a number of sectors with, in some cases, substantial growth year on year. We are, however, talking predominantly about non-eurozone countries such as Australia, Canada, Switzerland, which grew by EUR15bn (+33%), EUR14bn (+29%) and EUR11bn (+13%) respectively. Out of the eurozone, merely Belgium continued to grow at a substantial pace, adding EUR 4bn (+51%) to its outstanding covered bond volumes.

> Figure 1: Outstanding covered bonds by collateral type (LHS) as well as currency (RHS) in EUR bn



Source: Crédit Agricole CIB

> Figure 2: Outstanding covered bonds by country as well as change vs. 2013 (EUR bn)



Source: Crédit Agricole CIB

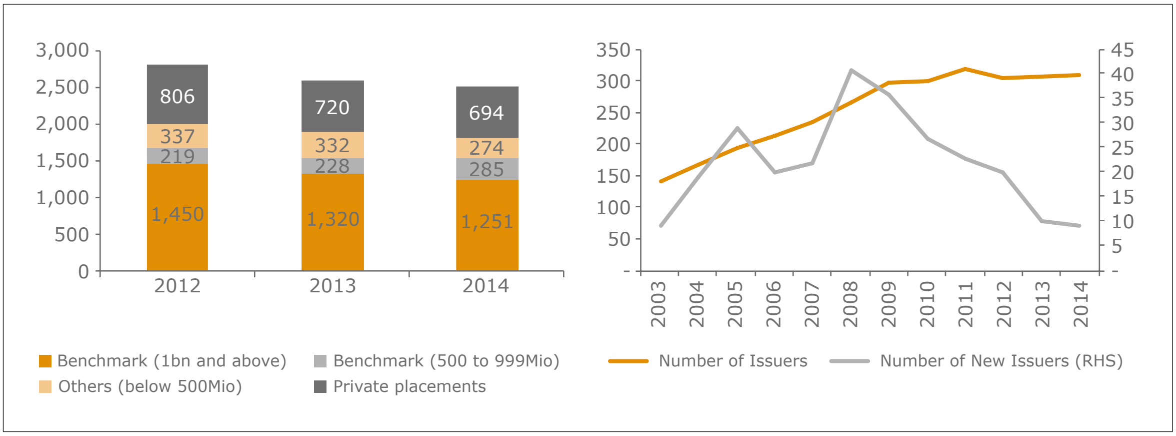
Despite the significant drop, the German Pfandbrief market is still the biggest covered bond market across collateral types with EUR402bn. With EUR375bn the Danish market has however edged very close to the number one spot and further increased the distance to the number three, Spain. The Danes are also the clear number one when only looking at mortgage backed covered bonds. With EUR325bn, French covered bonds occupy fourth spot, the same as last year. Before the non-eurozone sectors that proved to be the growth engines this year, they will have to continue the growth for another few years in order to catch up with the more seasoned markets at the top.

At the end of 2014, there were covered bonds outstanding in 29 countries spreading across the globe from Australia to Canada and most of Europe. No new country joined in 2014, however. The number of issuers also remained broadly stable in 2014 at 312 after 310 last year. On the one hand we had a total of 9 new issuers in Austria (1), Germany (6), Italy (1) and Norway (1) while on the other hand issuers from the Italy (1), Norway (1), South Korea (1), and United Kingdom (1).

As can also be seen from the figures above, despite the many discussions about covered bonds being used for additional collateral types, the market is heavily focused on the two most traditional collateral classes – mortgages (83% after 82% in 2013) and public sector assets (16% after 18% in 2013). Ship and aircraft mortgages only represent 0.4% of the market roughly keeping the same share as in 2013.

Having seen a big surge in volumes as banks in a number of countries used retained covered bonds as repo collateral during the crisis, the private placement category saw a big drop in 2013 (-85bn or 11%) as European lenders paid back part of their long-term refinancing operations (LTRO) money and consequently cancelled out retained covered bonds. In 2014 this category did continue to fall (EUR-26bn or 4%), the biggest contributor to the falling volumes were however benchmark markets with issues above EUR 1bn (EUR-69bn or -5%). Instead, many issuers focused on smaller sized benchmark deals (EUR+57bn or +25%) that were a better fit from an ALM angle.

> Figure 3: Outstanding covered bonds by issue type (LHS) in EURbn as well as number of issuers and new issuers (RHS)



Source: Crédit Agricole CIB

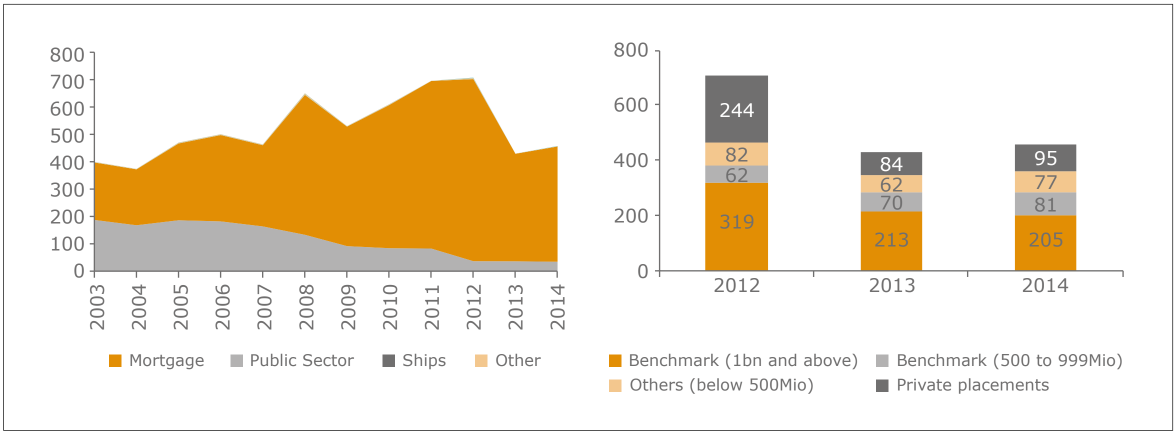
Covered bond markets continued to be dominated by fixed rate bonds. Despite the low interest rate environment this coupon type continues to make up 78% of the market, a similar number to 2013. Floating rate covered bonds are predominantly either from domestic covered bond markets in the Nordics or retained bonds by issuers. Much of the retained covered bonds were issued in FRN format to minimise ECB repo haircuts. But other than for senior unsecured, covered bonds' role as long-term investments that investors use to build up duration has prevented a surge in FRN demand despite the low yield levels.

Looking at currencies, the biggest contraction took place in EUR (similar to 2013). When thinking about the countries with the biggest absolute drop in volumes (Spain and Germany), this should not come as a surprise. EUR denominated covered bonds fell by EUR110bn (-5%). Covered bonds denominated in domestic currencies such as DKK, SEK, NOK, AUD or CAD actually grew by EUR 12bn (+2%). Other currencies (so i.e. Canadians issuing in USD or Germans issuing in GBP) also grew by 2%. This is in fact only another side of the same coin (growth taking place outside of Europe) as issuers from i.e. Canada or Australia have continued to issue in USD while redemption volumes are rather low compared to EUR markets.

EVOLUTION OF COVERED BOND ISSUANCE 2014

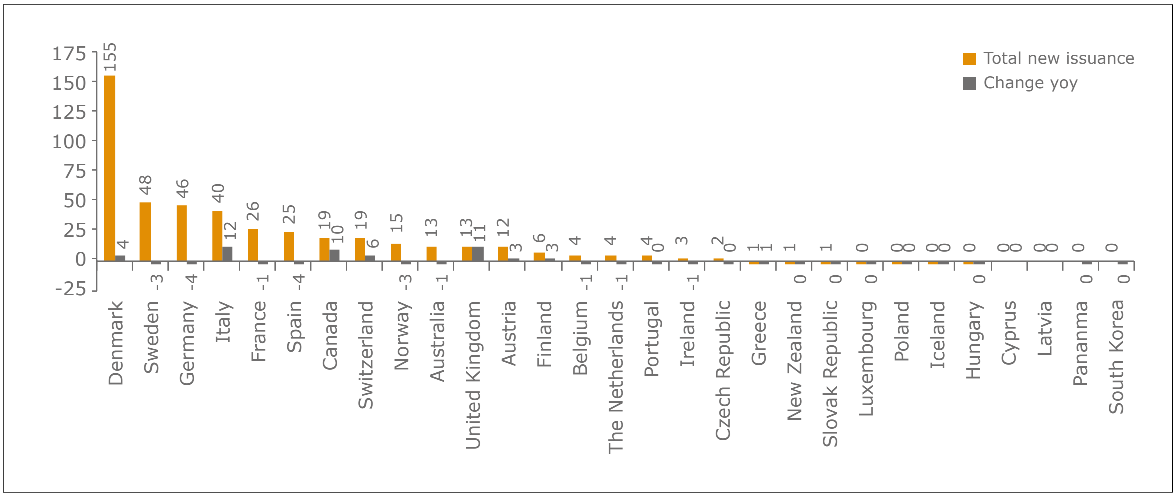
In 2013 covered bond issuance took a fairly severe beating compared to 2012. Volumes dropped by EUR277bn or 39%. In 2014, however, as outstanding volumes started to stabilise and only fall moderately, we have seen new issue volumes register some cautious again. Total new issuance in 2014 came in at EUR458bn which is 6% above the 2013 number.

> Figure 4: Covered bond new issuance by collateral type (LHS) as well as currency (RHS) in EUR bn



Source: Crédit Agricole CIB

> Figure 5: Covered bonds new issuance by country as well as change vs. 2013 (EUR bn)



Source: Crédit Agricole CIB

Denmark is still by far the country with the largest new issue volumes (EUR155bn). This represents 42% of the existing Danish covered bond stock. Issuers in the country are shifting the annual auctions from the short end to longer maturities so the annual refinancing volumes will come down over time. Nonetheless, the gap to the second largest country in terms of issuance is quite substantial so the top spot will remain in the Nordic country for the foreseeable future. Sweden had the second largest new issuance in 2014 with EUR48bn.

The biggest growth in new issuance compared to 2013 did, however, take place in Italy (EUR+12bn mainly in private placements) as well as Canada (EUR+10bn) and the United Kingdom (EUR+11bn).

In a similar trend to the outstanding volumes, issuers in 2014 did concentrate more on smaller benchmark markets in EUR (EUR+10bn). In addition to this, we did have some additional private placement issuance mainly due to a slight increase in the use of retained covered bonds by some issuers to collateralise the targeted long-term refinancing operations (TLTROs) late in 2014. This would also explain some of the increase in FRN issuance compared to last year (EUR+27bn).

Last but not least, looking at currencies, issues in domestic currencies went up the most (EUR+19bn). The additional EUR issuance most likely came mainly from the private placement buckets and retained issuance as explained above. Issuance in other currencies on the other hand dropped by EUR5bn despite the overall outstanding volumes increasing slightly compared to 2013. Lower redemption volumes in these markets are the main explanation here.

HOW HAS 2015 STARTED AND WHAT COULD 2016 HOLD…?

Covered bond benchmark issuance across currencies has been more active so far in 2015 than was the case last year. At the end of June, we have seen EUR 82bn equivalent across EUR, USD, GBP, CAD and AUD benchmark deals. This compares with around EUR 75bn equivalent in 2014.

Issuance patterns overall have, however, been dominated by the quantitative easing (QE) programmes of the Eurosystem.

> The announcement of the CBPP 3 had initially led many issuers (also those not eligible for the CBPP3) to focus on EUR markets as investors were still positive about the QE impact on spreads and happy to buy. During Q1 lower and even negative yields then started to push EUR issuance towards the longer end while at the same time investor demand started to drop. Q1 EUR benchmark issuance volumes were however still slightly above last year's figure.

> From March onwards, however, markets in EUR space became increasingly difficult to access even for CBPP 3 eligible issuers and the focus shifted more towards USD issuance. The share of EUR benchmark deals in the overall benchmark totals dropped from 81% in February to as low as 39% in May. The EUR2.4bn covered bond EUR benchmarks issued during May were also the lowest May volume in over a decade.

With EUR benchmark redemptions lower than they were last year (EUR139bn vs. EUR152bn in 2014) the market contraction at least in benchmark space should be yet once more less pronounced than it was the previous year. The slowdown in the drop of outstanding volumes that has started last year could thus continue in 2015 despite the impact the QE has on investor demand in EUR markets. There are other currency areas that issuers can make use of and they are doing just that. Domestic currencies as well as other currencies apart from the EUR are set to benefit the most in volume growth terms by the end of this year.

Unlike in 2014, we will also see the covered bond community grow with at least one new country looking to join (Singapore) and others reviving (i.e. Korea) or expanding (i.e. Poland or Turkey) their markets. Not all of them might, however, focus on EURs and with the Covered Bond Purchase Programme 3 (CBPP3) remaining in place for all of this and a large part of next year, the covered bond market might just continue to become a little bit less EUR centric.

5.2 STATISTICS

5.2.1 TOTAL

Outstanding (in EUR million)	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Total CB Outstanding										
Public Sector	894,944	915,003	899,500	815,550	733,076	653,022	616,551	543,977	464,761	408,617
Mortgage	772,081	958,415	1,112,594	1,447,235	1,644,362	1,836,449	2,041,311	2,253,327	2,125,402	2,085,080
Ships	10,586	11,341	12,167	16,327	15,151	14,527	12,640	13,571	11,306	9,824
Others	-	-	-	-	-	-	-	506	506	1,006
Total Outstanding	1,677,611	1,884,759	2,024,262	2,279,112	2,392,589	2,503,997	2,670,502	2,811,382	2,601,974	2,504,527
Public Placements										
Benchmark (1bn and above)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	1,449,751	1,322,047	1,250,756
Benchmark (500 to 999Mio)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	218,860	227,896	285,307
Others (below 500Mio)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	337,127	331,953	274,447
Private Placements	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	805,644	720,078	694,018
Total	1,677,611	1,884,759	2,024,262	2,279,112	2,392,589	2,503,997	2,670,502	2,811,382	2,601,974	2,504,527*
Denominated in EURO	1,336,837	1,326,648	1,555,576	1,653,013	1,672,557	1,703,410	1,834,407	1,928,951	1,743,185	1,630,760
Denominated in domestic currency	278,597	346,388	364,936	509,403	610,742	674,389	673,074	691,401	670,680	682,382
Denominated in other currencies	62,178	57,121	103,749	116,695	109,291	126,197	163,020	191,029	188,110	191,386
Total	1,677,611	1,884,759*	2,024,261	2,279,112	2,392,589	2,503,997	2,670,501	2,811,381	2,601,974	2,504,527
Outstanding fixed coupon	1,379,653	1,505,880	1,737,822	1,748,656	1,844,952	1,955,480	2,095,679	2,120,414	2,017,241	1,941,486
Outstanding floating coupon	178,093	203,972	255,458	498,205	511,725	507,882	542,469	650,856	547,742	534,741
Outstanding other	25,557	20,305	30,982	32,252	35,913	40,635	32,354	40,111	36,989	28,301
Sum	1,677,611*	1,884,759*	2,024,261	2,279,113	2,392,590	2,503,997	2,670,502	2,811,381	2,601,973	2,504,528
Number of Programmes	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	412	422
Number of Issuers	195	215	236	268	301	303	322	308	309	312

Issuance (in EUR million)	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Total CB Issuance										
Public Sector	186,098	181,992	163,611	132,988	91,526	84,018	82,711	36,495	36,096	34,537
Mortgage	280,671	315,502	296,779	511,292	436,816	522,921	612,417	665,642	392,998	421,168
Ships	3,579	3,334	3,143	6,289	2,221	3,325	1,016	4,643	761	1,319
Others	-	-	-	-	-	-	-	506	-	500
Total Issuance	470,348	500,829	463,533	650,569	530,563	610,264	696,144	707,286	429,855	457,524
Public Placements										
Benchmark (1bn and above)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	319,064	212,808	205,264
Benchmark (500 to 999Mio)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	62,032	70,233	80,815
Others (below 500Mio)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	82,450	62,376	76,527
Private Placements	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	243,740	84,440	94,917
Total	470,348	500,829	463,533	650,569	530,563	610,264	696,144	707,285	429,856*	457,522*
Denominated in EURO	284,635	344,027	332,243	385,053	302,589	373,730	437,190	405,271	213,868	227,734
Denominated in domestic currency	153,030	127,961	100,317	248,869	215,370	200,886	207,701	249,631	188,186	207,112
Denominated in other currencies	28,876	28,840	30,973	16,647	12,603	35,648	51,252	52,384	27,801	22,678
Total	470,346*	500,828	463,533	650,569	530,562	610,264	696,143	707,286	429,855	457,523
Issuance fixed coupon	375,583	396,931	373,842	350,866	405,130	492,587	497,465	271,042	337,650	338,213
Issuance floating coupon	67,387	55,828	85,017	292,524	120,902	115,329	195,736	410,994	91,417	118,232
Issuance other	9,860	6,035	4,673	7,179	4,530	2,348	2,943	25,250	790	1,079
Total	470,348*	500,828*	463,532	650,569	530,563	610,264	696,144	707,285	429,857	457,524
Number of New Issuers	29	20	22	41	36	27	23	20	8	9

Please note that a few changes were undertaken in 2013 to the way data is grouped and shown. These changes impact the figures from 2012 onwards. A number of them, especially the size and placement type category changes, are substantial to how data is displayed. Backdating data to fit the new categories and maintaining consistent data history for previous years is a major challenge. Therefore, there is a full dataset going back to 2003 for some countries while there is only data from 2012 going forward for others. Consequently, on the aggregate covered bond market level, only data for the new categorisation for 2012 and 2013 is shown. The old categories together with the historic data can be found on the 2012 edition of the ECBC Fact Book. For further information on these changes, please see the Statistics introduction of the Fact Book.

Please note that the statistics contain "n.a." when data is not available, "-" when the value is zero and "*" indicates that the figure in question does not correspond to the sum of the above sub-components due to the unavailability in some countries of these breakdowns. In addition, please note that totals are calculated using available data only, and that any fluctuations of values in this table over time may be partly due to one or more countries' data becoming available or unavailable from one year to the next. In order to be sure about what causes changes in the totals, please see the individual country statistics. Finally, please also note that any small difference between Totals in the same year is due to rounding.

Source: EMF-ECBC

5.2.2 TOTAL 2014 STATISTICS BY TYPE OF ASSETS

COVERED BONDS OUTSTANDING 2014 in EUR million						
	Public Sector	Mortgage	Ships	Others	Mixed Assets	TOTAL
Australia	-	61,326	-	-	-	61,326
Austria	19,279	22,450	-	-	-	41,729
Belgium	1,750	10,575	-	-	-	12,325
Canada	-	64,836	-	-	-	64,836
Cyprus	-	1,000	-	-	-	1,000
Czech Republic	-	11,106	-	-	-	11,106
Denmark	-	369,978	5,013	-	-	374,991
Finland	-	32,031	-	-	-	32,031
France	67,696	188,925	-	-	68,896	325,517
Germany	206,535	189,936	4,811	1,006	-	402,288
Greece	-	14,546	-	-	-	14,546
Hungary	-	3,272	-	-	-	3,272
Iceland	-	927	-	-	-	927
Ireland	20,258	18,473	-	-	-	38,731
Italy	8,700	122,464	-	-	-	131,164
Latvia	-	-	-	-	-	-
Luxembourg	16,002	-	-	-	-	16,002
The Netherlands	-	58,850	-	-	-	58,850
New Zealand	-	9,464	-	-	-	9,464
Norway	1,820	102,704	-	-	-	104,524
Panama	-	247	-	-	-	247
Poland	82	882	-	-	-	964
Portugal	400	33,711	-	-	-	34,111
Slovak Republic	-	3,939	-	-	-	3,939
South Korea	-	1,349	-	-	-	1,349
Spain	25,495	282,568	-	-	-	308,063
Sweden	-	209,842	-	-	-	209,842
Switzerland	-	100,436	-	-	-	100,436
United Kingdom	6,152	130,797	-	-	-	136,949
United States	-	4,000	-	-	-	4,000
Total	**374,169**	**2,050,633**	**9,824**	**1,006**	**68,896**	**2,504,527**

COVERED BONDS ISSUANCE 2014 in EUR million						
	Public Sector	Mortgage	Ships	Others	Mixed Assets	TOTAL
Australia	-	12,716	-	-	-	12,716
Austria	5,146	7,111	-	-	-	12,257
Belgium	1,750	2,387	-	-	-	4,137
Canada	-	19,275	-	-	-	19,275
Cyprus	-	-	-	-	-	-
Czech Republic	-	2,188	-	-	-	2,188
Denmark	-	154,310	399	-	-	154,709
Finland	-	6,469	-	-	-	6,469
France	5,318	14,483	-	-	6,149	25,950
Germany	15,334	29,145	920	500	-	45,899
Greece	-	750	-	-	-	750
Hungary	-	91	-	-	-	91
Iceland	-	91	-	-	-	91
Ireland	-	2,535	-	-	-	2,535
Italy	1,000	39,475	-	-	-	40,475
Latvia	-	-	-	-	-	-
Luxembourg	398	-	-	-	-	398
The Netherlands	-	3,910	-	-	-	3,910
New Zealand	-	750	-	-	-	750
Norway	664	14,474	-	-	-	15,138
Panama	-	-	-	-	-	-
Poland	-	269	-	-	-	269
Portugal	-	3,825	-	-	-	3,825
Slovak Republic	-	654	-	-	-	654
South Korea	-	-	-	-	-	-
Spain	1,853	23,038	-	-	-	24,891
Sweden	-	48,424	-	-	-	48,424
Switzerland	-	19,193	-	-	-	19,193
United Kingdom	-	12,529	-	-	-	12,529
United States	-	-	-	-	-	-
Total	**31,463**	**418,094**	**1,319**	**500**	**6,149**	**457,524**

Source: EMF-ECBC

5.2.3 AUSTRALIA

Outstanding (in EUR million)	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Total Covered Bonds Outstanding										
Public Sector	-	-	-	-	-	-	-	-	-	-
Mortgage	-	-	-	-	-	-	2,142	34,902	46,021	61,326
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Outstanding	-	-	-	-	-	-	2,142	34,902	46,021	61,326
Public Placement										
Benchmark (1bn and above)	-	-	-	-	-	-	-	25,443	36,938	38,224
Benchmark (500Mio - 999Mio)	-	-	-	-	-	-	966	3,666	2,670	5,822
Others (below 500Mio)	-	-	-	-	-	-	1,176	2,150	1,118	5,434
Private Placement	-	-	-	-	-	-	-	3,643	5,295	11,846
Total	-	-	-	-	-	-	2,142	34,902	46,021	61,326
Denominated in EURO	-	-	-	-	-	-	-	10,242	14,355	21,415
Denominated in domestic currency	-	-	-	-	-	-	-	9,676	9,012	10,526
Denominated in other currencies	-	-	-	-	-	-	2,142	14,984	22,654	29,385
Total	-	-	-	-	-	-	2,142	34,902	46,021	61,326
Outstanding fixed coupon	-	-	-	-	-	-	2,142	27,640	38,198	52,259
Outstanding floating coupon	-	-	-	-	-	-	-	7,262	7,823	9,066
Outstanding other	-	-	-	-	-	-	-	-	-	-
Total	-	-	-	-	-	-	2,142	34,902	46,021	61,326
Number of Programmes	-	-	-	-	-	-	n.a.	5	5	5
Number of Issuers	-	-	-	-	-	-	3	5	5	5

Issuance (in EUR million)	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Total Covered Bonds Issuance										
Public Sector	-	-	-	-	-	-	-	-	-	-
Mortgage	-	-	-	-	-	-	2,142	32,731	13,519	12,716
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Issuance	-	-	-	-	-	-	2,142	32,731	13,519	12,716
Public Placement										
Benchmark (1bn and above)	-	-	-	-	-	-	-	25,443	10,907	10,001
Benchmark (500Mio - 999Mio)	-	-	-	-	-	-	966	2,698	750	-
Others (below 500Mio)	-	-	-	-	-	-	1,176	947	-	579
Private Placement	-	-	-	-	-	-	-	3,643	1,863	2,137
Total	-	-	-	-	-	-	2,142	32,731	13,520	12,716
Denominated in EURO	-	-	-	-	-	-	-	10,242	4,112	7,060
Denominated in domestic currency	-	-	-	-	-	-	-	9,676	1,037	1,338
Denominated in other currencies	-	-	-	-	-	-	2,142	12,813	8,370	4,318
Total	-	-	-	-	-	-	2,142	32,731	13,519	12,716
Issuance fixed coupon	-	-	-	-	-	-	2,142	25,469	12,066	11,625
Issuance floating coupon	-	-	-	-	-	-	-	7,262	1,455	1,091
Issuance other	-	-	-	-	-	-	-	-	-	-
Total	-	-	-	-	-	-	2,142	32,731	13,521	12,716
Number of New Issuers	-	-	-	-	-	-	3	2	-	-

Source: Macquarie Group, ECBC

5.2.4 AUSTRIA

Outstanding (in EUR million)	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Total Covered Bonds Outstanding										
Public Sector	13,038	15,615	15,200	17,326	19,617	19,555	25,116	25,831	23,682	19,279
Mortgage	4,000	3,880	4,125	4,973	5,317	7,645	17,174	17,010	18,854	22,450
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Outstanding	17,038	19,495	19,325	22,299	24,934	27,200	42,290	42,841	42,536	41,729
Public Placement										
Benchmark (1bn and above)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	6,000	7,087	5,000	3,000
Benchmark (500Mio - 999Mio)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	9,915	11,328	12,870	13,050
Others (below 500Mio)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	5,821	5,897	87	-
Private Placement	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	20,554	18,529	24,579	25,679
Total	17,038	19,495	19,325	22,299	24,934	27,200	42,290	42,841	42,536	41,729
Denominated in EURO	15,691	17,703	17,304	19,664	24,002	21,510	37,576	39,068	39,184	39,287
Denominated in domestic currency	-	-	-	-	-	-	-	-	-	-
Denominated in other currencies	1,347	1,792	2,021	2,634	932	5,690	4,714	3,773	3,352	2,442
Total	17,038	19,495	19,325	22,298	24,934	27,200	42,290	42,841	42,536	41,729
Outstanding fixed coupon	13,497	17,207	18,111	19,189	16,593	17,900	32,275	32,696	34,793	29,680
Outstanding floating coupon	3,324	2,062	1,029	3,110	6,309	6,600	7,650	7,750	7,342	12,049
Outstanding other	217	226	185	-	2,032	2,700	2,364	2,395	402	-
Total	17,038	19,495	19,325	22,299	24,934	27,200	42,290	42,841	42,536	41,729
Number of Programmes	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	39	45
Number of Issuers	22	23	24	25	26	23	24	26	27	28

Issuance (in EUR million)	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Total Covered Bonds Issuance										
Public Sector	3,591	3,110	3,131	9,361	2,501	8,125	7,114	6,882	3,373	5,146
Mortgage	214	2,176	1,959	1,321	1,442	3,600	3,664	3,805	6,093	7,111
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Issuance	3,805	5,286	5,090	10,682	3,943	11,725	10,778	10,687	9,466	12,257
Public Placement										
Benchmark (1bn and above)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	3,000	1,000	-	-
Benchmark (500Mio - 999Mio)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	2,750	2,500	3,800	3,000
Others (below 500Mio)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	321	318	-	-
Private Placement	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	4,707	6,869	5,666	9,256
Total	3,805	5,286	5,090	10,682	3,943	11,725	10,778	10,687	9,466	12,256
Denominated in EURO	n.a.	4,899	4,861	10,362	3,943	10,725	10,008	10,447	9,466	12,256
Denominated in domestic currency	n.a.	-	-	-	-	-	-	-	-	-
Denominated in other currencies	n.a.	387	229	320	-	1,000	770	240	-	-
Total	3,805	5,286	5,090	10,682	3,943	11,725	10,778	10,687	9,466	12,256
Issuance fixed coupon	n.a.	3,807	4,577	8,255	3,252	10,200	5,922	8,155	6,609	4,671
Issuance floating coupon	n.a.	1,478	490	2,262	435	525	4,561	2,201	2,812	7,346
Issuance other	n.a.	-	23	165	256	1,000	295	331	45	239
Total	3,805	5,286	5,090	10,682	3,943	11,725	10,778	10,687	9,466	12,256
Number of New Issuers	7	1	1	1	1	2	1	2	1	1

5.2.5 BELGIUM

Outstanding (in EUR million)	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Total Covered Bonds Outstanding										
Public Sector	-	-	-	-	-	-	-	-	-	1,750
Mortgage	-	-	-	-	-	-	-	2,590	8,188	10,575
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Outstanding	-	-	-	-	-	-	-	2,590	8,188	12,325
Public Placement										
Benchmark (1bn and above)	-	-	-	-	-	-	-	2,500	4,500	5,750
Benchmark (500Mio - 999Mio)	-	-	-	-	-	-	-	-	2,500	5,175
Others (below 500Mio)	-	-	-	-	-	-	-	-	-	-
Private Placement	-	-	-	-	-	-	-	90	1,188	1,400
Total	-	-	-	-	-	-	-	2,590	8,188	12,325
Denominated in EURO	-	-	-	-	-	-	-	2,590	8,188	12,325
Denominated in domestic currency	-	-	-	-	-	-	-	-	-	-
Denominated in other currencies	-	-	-	-	-	-	-	-	-	-
Total	-	-	-	-	-	-	-	2,590	8,188	12,325
Outstanding fixed coupon	-	-	-	-	-	-	-	2,590	8,188	12,185
Outstanding floating coupon	-	-	-	-	-	-	-	-	-	140
Outstanding other	-	-	-	-	-	-	-	-	-	-
Total	-	-	-	-	-	-	-	2,590	8,188	12,325
Number of Programmes	-	-	-	-	-	-	-	2	3	4
Number of Issuers	-	-	-	-	-	-	-	2	3	3

Issuance (in EUR million)	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Total Covered Bonds Issuance										
Public Sector	-	-	-	-	-	-	-	-	-	1,750
Mortgage	-	-	-	-	-	-	-	2,590	5,598	2,387
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Issuance	-	-	-	-	-	-	-	2,590	5,598	4,137
Public Placement										
Benchmark (1bn and above)	-	-	-	-	-	-	-	2,500	2,000	1,250
Benchmark (500Mio - 999Mio)	-	-	-	-	-	-	-	-	2,500	2,675
Others (below 500Mio)	-	-	-	-	-	-	-	-	-	-
Private Placement	-	-	-	-	-	-	-	90	1,098	212
Total	-	-	-	-	-	-	-	2,590	5,598	4,137
Denominated in EURO	-	-	-	-	-	-	-	2,590	5,598	4,137
Denominated in domestic currency	-	-	-	-	-	-	-	-	-	-
Denominated in other currencies	-	-	-	-	-	-	-	-	-	-
Total	-	-	-	-	-	-	-	2,590	5,598	4,137
Issuance fixed coupon	-	-	-	-	-	-	-	2,590	5,598	3,997
Issuance floating coupon	-	-	-	-	-	-	-	-	-	140
Issuance other	-	-	-	-	-	-	-	-	-	-
Total	-	-	-	-	-	-	-	2,590	5,598	4,137
Number of New Issuers	-	-	-	-	-	-	-	2	1	-

5.2.6 CANADA

Outstanding (in EUR million)	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Total Covered Bonds Outstanding										
Public Sector	-	-	-	-	-	-	-	-	-	-
Mortgage	-	-	2,000	6,574	7,525	18,003	38,610	49,121	50,459	64,836
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Outstanding	-	-	2,000	6,574	7,525	18,003	38,610	49,121	50,459	64,836
Public Placement										
Benchmark (1bn and above)	-	-	n.a.	6,280	6,238	14,600	34,009	43,495	45,372	56,379
Benchmark (500Mio - 999Mio)	-	-	n.a.		496	2,230	3,653	4,130	1,205	3,970
Others (below 500Mio)	-	-	n.a.	294	792	1,173	948	1,119	3,123	799
Private Placement	-	-	n.a.	-	-	-	-	378	759	3,689
Total	-	-	2,000	6,574	7,525	18,003	38,610	49,121	50,459	64,836
Denominated in EURO	-	-	2,000	6,574	6,574	4,250	4,250	2,576	6,750	19,250
Denominated in domestic currency	-	-	-	-	496	1,201	2,043	2,055	1,840	1,387
Denominated in other currencies	-	-	-	-	455	12,552	32,317	44,490	41,869	44,200
Total	-	-	2,000	6,574	7,525	18,003	38,610	49,121	50,459	64,836
Outstanding fixed coupon	-	-	2,000	6,250	6,999	17,763	38,610	48,743	48,962	60,588
Outstanding floating coupon	-	-	-	324	526	240	-	378	1,497	4,249
Outstanding other	-	-	-	-	-	-	-	-	-	-
Total	-	-	2,000	6,574	7,525	18,003	38,610	49,121	50,459	64,836
Number of Programmes	-	-	-	-	-	-	-	-	9	13
Number of Issuers	-	-	1	3	3	5	7	7	7	7

Issuance (in EUR million)	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Total Covered Bonds Issuance										
Public Sector	-	-	-	-	-	-	-	-	-	-
Mortgage	-	-	2,000	4,574	951	12,650	20,441	12,941	9,354	19,275
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Issuance	-	-	2,000	4,574	951	12,650	20,441	12,941	9,354	19,275
Public Placement										
Benchmark (1bn and above)	-	-	n.a.	4,280	-	10,334	19,036	11,942	9,030	14,851
Benchmark (500Mio - 999Mio)	-	-	n.a.	-	496	1,667	1,405	455	-	1,661
Others (below 500Mio)	-	-	n.a.	294	455	649	-	166	-	321
Private Placement	-	-	n.a.	-	-	-	-	378	324	2,441
Total	-	-	2,000	4,574	951	12,650	20,441	12,941	9,354	19,275
Denominated in EURO	-	-	2,000	4,250	-	-	-	-	5,500	12,500
Denominated in domestic currency	-	-	-	-	496	638	832	-	-	-
Denominated in other currencies	-	-	-	324	455	12,012	19,608	12,941	3,854	6,775
Total	-	-	2,000	4,574	951	12,650	20,440	12,941	9,354	19,275
Issuance fixed coupon	-	-	2,000	4,250	749	12,650	20,441	12,563	8,219	16,618
Issuance floating coupon	-	-	-	-	202	-	-	-	1,135	2,657
Issuance other	-	-	-	324	-	-	-	378	-	-
Total	-	-	2,000	4,574	951	12,650	20,441	12,941	9,354	19,275
Number of New Issuers	-	-	1	2	-	2	2	-	-	-

5.2.7 CYPRUS

Outstanding (in EUR million)	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Total Covered Bonds Outstanding										
Public Sector	-	-	-	-	-	-	-	-	-	-
Mortgage	-	-	-	-	-	-	5,200	4,550	1,000	1,000
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Outstanding	-	-	-	-	-	-	5,200	4,550	1,000	1,000
Public Placement										
Benchmark (1bn and above)	-	-	-	-	-	-	-	-	-	-
Benchmark (500Mio - 999Mio)	-	-	-	-	-	-	-	-	-	-
Others (below 500Mio)	-	-	-	-	-	-	-	-	-	-
Private Placement	-	-	-	-	-	-	5,200	4,550	1,000	1,000
Total	-	-	-	-	-	-	5,200	4,550	1,000	1,000
Denominated in EURO	-	-	-	-	-	-	5,200	4,550	1,000	1,000
Denominated in domestic currency	-	-	-	-	-	-	-	-	-	-
Denominated in other currencies	-	-	-	-	-	-	-	-	-	-
Total	-	-	-	-	-	-	5,200	4,550	1,000	1,000
Outstanding fixed coupon	-	-	-	-	-	-	-	-	-	-
Outstanding floating coupon	-	-	-	-	-	-	5,200	4,550	1,000	1,000
Outstanding other	-	-	-	-	-	-	-	-	-	-
Total	-	-	-	-	-	-	5,200	4,550	1,000	1,000
Number of Programmes	-	-	-	-	-	-	n.a.	n.a.	1	1
Number of Issuers	-	-	-	-	-	-	2	2	1	1

Issuance (in EUR million)	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Total Covered Bonds Issuance										
Public Sector	-	-	-	-	-	-	-	-	-	-
Mortgage	-	-	-	-	-	-	5,200	-	-	-
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Issuance	-	-	-	-	-	-	5,200	-	-	-
Public Placement										
Benchmark (1bn and above)	-	-	-	-	-	-	-	-	-	-
Benchmark (500Mio - 999Mio)	-	-	-	-	-	-	-	-	-	-
Others (below 500Mio)	-	-	-	-	-	-	-	-	-	-
Private Placement	-	-	-	-	-	-	5,200	-	-	-
Total	-	-	-	-	-	-	5,200	-	-	-
Denominated in EURO	-	-	-	-	-	-	5,200	-	-	-
Denominated in domestic currency	-	-	-	-	-	-	-	-	-	-
Denominated in other currencies	-	-	-	-	-	-	-	-	-	-
Total	-	-	-	-	-	-	5,200	-	-	-
Issuance fixed coupon	-	-	-	-	-	-	-	-	-	-
Issuance floating coupon	-	-	-	-	-	-	5,200	-	-	-
Issuance other	-	-	-	-	-	-	-	-	-	-
Total	-	-	-	-	-	-	5,200	-	-	-
Number of New Issuers	-	-	-	-	-	-	2	-	-	-

5.2.8 CZECH REPUBLIC

Outstanding (in EUR million)	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Total Covered Bonds Outstanding										
Public Sector	-	-	-	-	-	-	-	-	-	-
Mortgage	4,452	5,543	8,213	8,091	8,179	8,234	8,546	9,056	10,355	11,106
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Outstanding	4,452	5,543	8,213	8,091	8,179	8,234	8,546	9,056	10,355	11,106
Public Placement										
Benchmark (1bn and above)	-	-	-	-	-	-	-	-	-	-
Benchmark (500Mio - 999Mio)	-	-	-	-	-	-	-	-	-	-
Others (below 500Mio)	3,710	4,682	6,613	6,502	5,439	5,454	5,194	5,522	6,731	4,316
Private Placement	742	861	1,600	1,589	2,740	2,780	3,352	3,534	3,624	6,790
Total	4,452	5,543	8,213	8,091	8,179	8,234	8,546	9,056	10,355	11,106
Denominated in EURO	-	42	39	35	119	128	111	571	914	735
Denominated in domestic currency	4,452	5,501	8,174	8,056	8,060	8,106	8,435	8,485	9,441	10,371
Denominated in other currencies	-	-	-	-	-	-	-	-	-	-
Total	4,452	5,543	8,213	8,091	8,179	8,234	8,546	9,056	10,355	11,106
Outstanding fixed coupon	3,619	4,615	5,871	5,752	3,756	3,608	3,740	3,280	6,110	5,279
Outstanding floating coupon	833	928	1,675	1,270	3,900	4,063	4,119	5,096	4,105	5,654
Outstanding other	-	-	667	1,069	523	563	687	680	140	173
Total	4,452	5,543	8,213	8,091	8,179	8,234	8,546	9,056	10,355	11,106
Number of Programmes	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	8	8
Number of Issuers	8	8	9	8	8	8	8	8	8	8

Issuance (in EUR million)	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Total Covered Bonds Issuance										
Public Sector	-	-	-	-	-	-	-	-	-	-
Mortgage	2,558	956	3,501	938	738	723	770	1,309	1,791	2,188
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Issuance	2,558	956	3,501	938	738	723	770	1,309	1,791	2,188
Public Placement										
Benchmark (1bn and above)	-	-	-	-	-	-	-	-	-	-
Benchmark (500Mio - 999Mio)	-	-	-	-	-	-	-	-	-	-
Others (below 500Mio)	2,068	875	3,347	938	187	705	711	742	622	369
Private Placement	490	81	154	-	551	18	59	567	1,169	1,819
Total	2,558	956	3,501	938	738	723	770	1,309	1,791	2,188
Denominated in EURO	-	42	-	-	89	18	-	500	886	286
Denominated in domestic currency	2,558	914	3,501	938	649	705	770	809	905	1,902
Denominated in other currencies	-	-	-	-	-	-	-	-	-	-
Total	2,558	956	3,501	938	738	723	770	1,309	1,791	2,188
Issuance fixed coupon	1,897	903	1,322	55	76	420	378	484	1,717	2,013
Issuance floating coupon	661	53	1,699	789	662	178	169	745	74	136
Issuance other	-	-	480	95	-	125	223	80	-	39
Total	2,558	956	3,501	938	738	723	770	1,309	1,791	2,188
Number of New Issuers	3	-	1	-	-	-	-	-	-	-

5.2.9 DENMARK

Outstanding (in EUR million)	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Total Covered Bonds Outstanding										
Public Sector	-	-	-	-	-	-	-	-	-	-
Mortgage	246,411	260,367	244,696	255,140	319,434	332,505	345,529	359,560	359,646	369,978
Ships	6,915	6,672	7,754	7,045	7,197	6,722	5,999	6,325	5,514	5,013
Others	-	-	-	-	-	-	-	-	-	-
Total Outstanding	253,326	267,039	252,450	262,185	326,631	339,227	351,528	365,885	365,160	374,991

Public Placement										
Benchmark (1bn and above)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	231,421	234,504	228,111
Benchmark (500Mio - 999Mio)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	52,156	54,170	64,229
Others (below 500Mio)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	80,692	74,355	78,721
Private Placement	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	1,616	2,131	3,931
Total	253,326	267,039	252,450	262,185	326,631	339,227	351,528	365,885	365,160	374,992

Denominated in EURO	18,432	18,743	19,547	22,520	37,675	42,848	43,753	46,451	40,856	38,682
Denominated in domestic currency	234,894	248,296	232,903	238,324	287,317	294,019	302,938	312,065	316,603	327,442
Denominated in other currencies	-	-	-	1,341	1,639	2,360	4,837	7,368	7,701	8,867
Total	253,326	267,039	252,450	262,185	326,631	339,227	351,528	365,885	365,160	374,991

Outstanding fixed coupon	209,667	208,623	178,953	184,636	254,894	267,075	275,092	285,754	284,483	285,721
Outstanding floating coupon	32,729	48,232	73,497	77,549	71,737	72,152	76,436	80,131	80,677	89,271
Outstanding other	10,930	10,184	-	-	-	-	-	-	-	-
Total	253,326	267,039	252,450	262,185	326,631	339,227	351,528	365,885	365,160	374,992

Number of Programmes	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	24	23
Number of Issuers	9	9	10	10	10	10	10	10	10	9

Issuance (in EUR million)	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Total Covered Bonds Issuance										
Public Sector	-	-	-	-	-	-	-	-	-	-
Mortgage	149,708	114,014	70,955	103,230	125,484	148,475	145,147	185,845	149,989	154,310
Ships	1,837	960	2,515	235	935	136	121	1,474	458	399
Others	-	-	-	-	-	-	-	-	-	-
Total Issuance	151,545	114,974	73,470	103,465	126,419	148,611	145,268	187,319	150,447	154,709

Public Placement										
Benchmark (1bn and above)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	140,705	112,880	78,323
Benchmark (500Mio - 999Mio)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	18,339	17,573	31,779
Others (below 500Mio)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	27,843	19,657	44,592
Private Placement	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	432	337	15
Total	151,545	114,974	73,470	103,465	126,419	148,611	145,268	187,319	150,447	154,709

Denominated in EURO	8,850	8,844	14,415	13,186	22,255	24,833	25,415	25,074	23,553	15,412
Denominated in domestic currency	142,695	106,130	59,055	90,279	101,183	122,374	116,911	158,335	124,331	134,368
Denominated in other currencies	-	-	-	-	2,981	1,404	2,942	3,910	2,563	4,929
Total	151,545	114,974	73,470	103,465	126,419	148,611	145,268	187,319	150,447	154,709

Issuance fixed coupon	123,590	93,771	50,757	89,888	122,851	133,846	128,195	-	130,290	131,949
Issuance floating coupon	27,955	21,203	22,713	13,577	3,568	14,765	17,073	163,680	20,157	22,760
Issuance other	-	-	-	-	-	-	-	23,638	-	-
Total	151,545	114,974	73,470	103,465	126,419	148,611	145,268	187,319	150,447	154,709

Number of New Issuers	-	-	1	-	-	-	-	-	-	-

Note: Since a large share of Danish mortgage covered bonds are tap-issued over a period of typically 3 years, Benchmark (1bn and above) issues and outstanding are defined as covered bond with more than EUR 1 bn in the year, the bond reach EUR 1 bn. The same way, Benchmark (500Mio - 999Mio) issues and outstanding are defined as covered bond with 500Mio – 999Mio euro in the year, the bond reach EUR 500 Mio, and at the same time does not exceed EUR 999 Mio. The definition includes both covered bonds denominated in DKK and in EUR. Danish covered bonds denominated in euro and issued in a jurisdiction outside Denmark are included in the Danish data.

5.2.10 FINLAND

Outstanding (in EUR million)	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Total Covered Bonds Outstanding										
Public Sector	-	-	-	-	-	-	-	-	-	-
Mortgage	1,500	3,000	4,500	5,750	7,625	10,125	18,839	26,684	29,783	32,031
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Outstanding	1,500	3,000	4,500	5,750	7,625	10,125	18,839	26,684	29,783	32,031
Public Placement										
Benchmark (1bn and above)	1,000	2,000	3,000	4,000	5,250	7,250	14,750	20,750	22,500	25,750
Benchmark (500Mio - 999Mio)	-	-	-	-	600	1,600	2,200	2,200	2,200	2,100
Others (below 500Mio)	500	1,000	1,500	1,750	1,775	1,275	1,606	2,874	4,115	3,116
Private Placement	-	-	-	-	-	-	283	861	969	1,065
Total	1,500	3,000	4,500	5,750	7,625	10,125	18,839	26,684	29,783	32,031
Denominated in EURO	1,500	3,000	4,500	5,750	7,625	10,125	18,453	26,114	29,230	31,738
Denominated in domestic currency	-	-	-	-	-	-	-	-	-	-
Denominated in other currencies	-	-	-	-	-	-	386	571	553	293
Total	1,500	3,000	4,500	5,750	7,625	10,125	18,839	26,684	29,783	32,031
Outstanding fixed coupon	1,000	2,250	3,750	4,750	6,500	9,250	17,863	23,247	26,425	28,665
Outstanding floating coupon	500	750	750	1,000	1,125	875	976	3,437	3,358	3,366
Outstanding other	-	-	-	-	-	-	-	-	-	-
Total	1,500	3,000	4,500	5,750	7,625	10,125	18,839	26,684	29,783	32,031
Number of Programmes	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	8	9
Number of Issuers	2	2	3	3	3	4	4	5	6	6

Issuance (in EUR million)	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Total Covered Bonds Issuance										
Public Sector	-	-	-	-	-	-	-	-	-	-
Mortgage	1,250	1,500	1,500	1,250	2,125	5,250	9,964	9,368	3,771	6,469
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Issuance	1,250	1,500	1,500	1,250	2,125	5,250	9,964	9,368	3,771	6,469
Public Placement										
Benchmark (1bn and above)	1,000	1,000	1,000	1,000	1,250	4,000	8,500	7,000	2,750	5,500
Benchmark (500Mio - 999Mio)	-	-	-	-	600	1,000	600	-	500	500
Others (below 500Mio)	250	500	500	250	275	250	581	1,790	370	469
Private Placement	-	-	-	-	-	-	283	578	151	-
Total	1,250	1,500	1,500	1,250	2,125	5,250	9,964	9,368	3,771	6,469
Denominated in EURO	1,250	1,500	1,500	1,250	2,125	5,250	9,578	9,186	3,771	6,283
Denominated in domestic currency	-	-	-	-	-	-	-	-	-	-
Denominated in other currencies	-	-	-	-	-	-	386	182	-	186
Total	1,250	1,500	1,500	1,250	2,125	5,250	9,964	9,368	3,771	6,469
Issuance fixed coupon	1,000	1,250	1,500	1,000	2,000	5,000	9,613	6,783	3,621	6,170
Issuance floating coupon	250	250	-	250	125	250	351	2,585	150	299
Issuance other	-	-	-	-	-	-	-	-	-	-
Total	1,250	1,500	1,500	1,250	2,125	5,250	9,964	9,368	3,771	6,469
Number of New Issuers	1	-	1	-	-	1	-	1	1	-

5.2.11 FRANCE

Outstanding (in EUR million)	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Total Covered Bonds Outstanding										
Public Sector	42,600	49,660	56,403	64,756	71,905	75,548	77,835	72,033	68,349	67,696
Mortgage	32,133	43,012	63,555	119,092	134,757	156,239	198,395	208,297	202,822	188,925
Mixed Assets	50,040	61,930	80,097	80,631	82,572	88,693	89,768	81,560	73,015	68,896
Others	-	-	-	-	-	-	-	-	-	-
Total Outstanding	124,773	154,602	200,055	264,479	289,234	320,480	365,998	361,890	344,185	325,517
Public Placement										
Benchmark (Above 1bn)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	241,775	209,885	208,784
Benchmark (500Mio - 1bn)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	4,949	23,992	14,788
Others	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	36,595	32,253	7,865
Private Placement	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	78,570	78,055	94,081
Total	124,773	154,602	200,055	264,479	289,234	320,480	365,998	361,890	344,186	325,517
Denominated in EURO	109,236	n.a.	165,779	226,922	256,798	285,501	327,874	331,212	316,562	303,435
Denominated in domestic currency	-	n.a.	-	-	-	-	-	-	-	-
Denominated in other currencies	15,537	n.a.	34,276	37,558	32,436	34,979	38,123	30,678	27,624	22,083
Total	124,773	154,602	200,055	264,480	289,234	320,480	365,998	361,890	344,186	325,517
Outstanding fixed coupon	30,465	n.a.	174,388	204,729	236,106	266,080	284,266	297,009	287,504	279,149
Outstanding floating coupon	n.a.	n.a.	10,502	48,633	42,600	43,710	75,068	47,805	43,002	32,725
Outstanding other	n.a.	n.a.	15,165	11,117	10,528	10,690	6,665	17,076	13,680	13,643
Total	124,773	154,602	200,055	264,479	289,234	320,480	365,998	361,890	344,186	325,517
Number of Programmes	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	23	21
Number of Issuers	5	6	7	10	14	16	19	20	21	21

Issuance (in EUR million)	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Total Covered Bonds Issuance										
Public Sector	9,070	12,134	15,271	11,354	13,915	12,508	8,851	1,150	4,179	5,318
Mortgage	6,397	12,637	21,670	59,734	29,373	42,895	84,416	49,260	19,637	14,483
Mixed Assets	13,150	17,263	23,682	8,549	15,824	17,261	8,719	8,101	3,498	6,149
Others	-	-	-	-	-	-	-	-	-	-
Total Issuance	28,617	42,034	60,623	79,637	59,112	72,664	101,986	58,511	27,314	25,950
Public Placement										
Benchmark (Above 1bn)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	25,672	12,250	15,250
Benchmark (500Mio - 1bn)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	1,185	5,550	4,250
Others	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	4,830	1,755	496
Private Placement	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	26,824	7,759	5,955
Total	28,617	42,034	60,623	79,637	59,112	72,664	101,986	58,511	27,314	25,950
Denominated in EURO	20,637	34,172	50,700	73,930	56,155	64,375	96,020	55,851	26,596	25,455
Denominated in domestic currency	-	-	-	-	-	-	-	-	-	-
Denominated in other currencies	7,980	7,862	9,923	5,708	2,957	8,289	5,967	2,660	718	495
Total	28,617	42,034	60,623	79,637	59,112	72,664	101,986	58,511	27,314	25,950
Issuance fixed coupon	14,904	n.a.	57,009	37,158	50,443	64,503	67,612	36,003	23,556	24,027
Issuance floating coupon	n.a.	n.a.	2,614	42,224	8,519	7,953	34,286	22,368	3,558	1,549
Issuance other	n.a.	n.a.	1,000	255	150	208	89	140	200	374
Total	28,617	42,034	60,623	79,637	59,112	72,664	101,986	58,511	27,314	25,950
Number of New Issuers	-	1	1	3	4	4	3	1	1	-

Note: The "Mixed assets" category refers to covered bonds that are backed by a mix of public sector assets, mortgage loans. The bonds (outstanding and issuance) have been allocated equally between mortgage and public sector categories in the total (5.2.1 section of the Fact Book).

5.2.12 GERMANY

Outstanding (in EUR million)	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Total Covered Bonds Outstanding										
Public Sector	734,713	720,835	677,656	578,974	486,406	412,090	355,673	301,125	245,961	206,535
Mortgage	237,547	223,306	206,489	217,367	225,100	219,947	223,676	215,999	199,900	189,936
Ships	3,670	4,669	4,413	9,282	7,954	7,805	6,641	7,246	5,792	4,811
Others	-	-	-	-	-	-	-	506	506	1,006
Total Outstanding	975,930	948,810	888,558	805,623	719,460	639,842	585,990	524,876	452,159	402,288
Public Placement										
Benchmark (1bn and above)	354,592	326,140	298,220	266,747	224,042	170,068	141,393	112,869	81,030	55,608
Benchmark (500Mio - 999Mio)	27,740	31,102	36,178	32,909	27,683	28,644	28,704	36,862	46,798	56,987
Others (below 500Mio)	185,578	155,379	92,675	62,805	66,030	46,344	43,634	75,244	63,864	60,229
Private Placement	408,020	436,189	461,485	443,162	401,705	394,786	372,259	299,901	260,467	229,464
Total	975,930	948,810	888,558	805,623	719,460	639,842	585,990	524,876	452,159	402,288
Denominated in EURO	952,485	922,878	863,594	778,623	690,510	620,420	565,529	506,639	437,737	387,772
Denominated in domestic currency	-	-	-	-	-	-	-	-	-	-
Denominated in other currencies	23,445	25,932	24,964	27,000	28,950	19,422	20,461	18,237	14,422	14,516
Total	975,930	948,810	888,558	805,623	719,460	639,842	585,990	524,876	452,159	402,288
Outstanding fixed coupon	845,386	823,130	789,338	689,124	619,364	546,791	493,983	433,787	375,537	339,705
Outstanding floating coupon	120,681	121,754	90,552	107,522	90,136	78,105	74,340	76,840	59,170	51,956
Outstanding other	9,863	3,926	8,668	8,976	9,959	14,946	17,667	14,249	17,452	10,627
Total	975,930	948,810	888,558	805,623	719,460	639,842	585,990	524,876	452,159	402,288
Number of Programmes	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	116	121
Number of Issuers	54	57	58	59	61	63	66	71	72	78

Issuance (in EUR million)	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Total Covered Bonds Issuance										
Public Sector	137,235	129,452	107,913	89,522	52,251	41,574	30,990	14,341	15,611	15,334
Mortgage	33,722	35,336	26,834	57,345	56,852	42,216	40,911	38,540	33,583	29,145
Ships	1,742	2,374	628	6,054	1,286	3,189	895	3,169	303	920
Others	-	-	-	-	-	-	-	506	-	500
Total Issuance	172,699	167,162	135,375	152,921	110,389	86,979	72,796	56,556	49,497	45,899
Public Placement										
Benchmark (1bn and above)	48,450	45,210	32,980	26,285	17,125	16,853	21,406	4,008	2,125	5,500
Benchmark (500Mio - 999Mio)	9,050	7,200	12,556	10,880	7,650	10,297	5,319	11,879	15,725	14,100
Others (below 500Mio)	49,395	24,525	12,437	30,172	18,732	11,835	15,632	11,816	11,816	9,045
Private Placement	65,804	90,227	77,402	85,584	66,882	47,994	30,439	28,853	19,831	17,254
Total	172,699	167,162	135,375	152,921	110,389	86,979	72,796	56,556	49,497	45,899
Denominated in EURO	163,931	159,340	131,807	149,137	107,488	84,459	68,585	52,608	45,757	42,811
Denominated in domestic currency	-	-	-	-	-	-	-	-	-	-
Denominated in other currencies	8,768	7,822	3,568	3,784	2,901	2,520	4,211	3,948	3,740	3,088
Total	172,699	167,162	135,375	152,921	110,389	86,979	72,796	56,556	49,497	45,899
Issuance fixed coupon	138,259	143,869	113,085	111,309	89,605	62,518	54,023	32,274	37,878	36,917
Issuance floating coupon	27,077	18,859	20,099	40,156	20,091	23,468	16,692	23,702	11,302	8,755
Issuance other	7,363	4,434	2,191	1,456	693	993	2,081	580	317	227
Total	172,699	167,162	135,375	152,921	110,389	86,979	72,796	56,556	49,497	45,899
Number of New Issuers	6	4	2	4	5	5	3	5	1	6

5.2.13 GREECE

Outstanding (in EUR million)	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**
Total Covered Bonds Outstanding										
Public Sector	-	-	-	-	-	-	-	-	-	-
Mortgage	-	-	-	5,000	6,500	19,750	19,750	18,046	16,546	14,546
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Outstanding	-	-	-	5,000	6,500	19,750	19,750	18,046	16,546	14,546
Public Placement										
Benchmark (1bn and above)	-	-	-	-	1,500	1,500	1,500	-	-	-
Benchmark (500Mio - 999Mio)	-	-	-	-	-	-	-	846	846	846
Others (below 500Mio)	-	-	-	-	-	-	-	-	-	-
Private Placement	-	-	-	5,000	5,000	18,250	18,250	17,200	15,700	13,700
Total	-	-	-	5,000	6,500	19,750	19,750	18,046	16,546	14,546
Denominated in EURO	-	-	-	5,000	6,500	19,750	19,750	18,046	16,546	14,546
Denominated in domestic currency	-	-	-	-	-	-	-	-	-	-
Denominated in other currencies	-	-	-	-	-	-	-	-	-	-
Total	-	-	-	5,000	6,500	19,750	19,750	18,046	16,546	14,546
Outstanding fixed coupon	-	-	-	-	1,500	1,500	1,500	846	846	846
Outstanding floating coupon	-	-	-	5,000	5,000	18,250	18,250	17,200	15,700	13,700
Outstanding other	-	-	-	-	-	-	-	-	-	-
Total	-	-	-	5,000	6,500	19,750	19,750	18,046	16,546	14,546
Number of Programmes	-	-	-	n.a.	n.a.	n.a.	n.a.	n.a.	6	6
Number of Issuers	-	-	-	3	3	4	4	4	4	4

Issuance (in EUR million)	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**
Total Covered Bonds Issuance										
Public Sector	-	-	-	-	-	-	-	-	-	-
Mortgage	-	-	-	5,000	1,500	17,250	5,000	-	-	750
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Issuance	-	-	-	5,000	1,500	17,250	5,000	-	-	750
Public Placement										
Benchmark (1bn and above)	-	-	-	-	1,500	-	-	-	-	-
Benchmark (500Mio - 999Mio)	-	-	-	-	-	-	-	-	-	-
Others (below 500Mio)	-	-	-	-	-	-	-	-	-	-
Private Placement	-	-	-	5,000	-	17,250	5,000	-	-	750
Total	-	-	-	5,000	1,500	17,250	5,000	-	-	750
Denominated in EURO	-	-	-	5,000	1,500	17,250	5,000	-	-	750
Denominated in domestic currency	-	-	-	-	-	-	-	-	-	-
Denominated in other currencies	-	-	-	-	-	-	-	-	-	-
Total	-	-	-	5,000	1,500	17,250	5,000	-	-	750
Issuance fixed coupon	-	-	-	-	1,500	-	-	-	-	-
Issuance floating coupon	-	-	-	5,000	-	17,250	5,000	-	-	750
Issuance other	-	-	-	-	-	-	-	-	-	-
Total	-	-	-	5,000	1,500	17,250	5,000	-	-	750
Number of New Issuers	-	-	-	3	-	2	1	-	-	-

5.2.14 HUNGARY

Outstanding (in EUR million)	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Total Covered Bonds Outstanding										
Public Sector	-	-	-	-	-	-	-	-	-	-
Mortgage	5,072	5,924	5,987	7,105	7,375	6,323	5,175	4,958	4,016	3,272
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Outstanding	5,072	5,924	5,987	7,105	7,375	6,323	5,175	4,958	4,016	3,272
Public Placement										
Benchmark (1bn and above)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	-	-	-
Benchmark (500Mio - 999Mio)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	2,290	-	-
Others (below 500Mio)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	865	20	-
Private Placement	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	1,803	3,996	3,272
Total	5,072	5,924	5,987	7,105	7,375	6,323	5,175	4,958	4,016	3,272
Denominated in EURO	540	1,547	1,784	2,879	3,799	2,904	2,167	1,863	1,616	1,116
Denominated in domestic currency	4,532	4,377	4,203	4,209	3,559	3,419	2,934	3,059	2,354	2,154
Denominated in other currencies	-	-	-	17	17		74	36	46	2
Total	5,072	5,924	5,987	7,105	7,375	6,323	5,175	4,958	4,016	3,272
Outstanding fixed coupon	4,587	5,214	5,080	4,086	6,737	5,713	3,195	3,318	2,650	2,205
Outstanding floating coupon	398	635	907	3,019	638	610	1,980	1,640	1,366	1,067
Outstanding other	87	75	-	-	-	-	-	-	-	-
Total	5,072	5,924	5,987	7,105	7,375	6,323	5,175	4,958	4,016	3,272
Number of Programmes	n.a	n.a	n.a	n.a	n.a	n.a	n.a	n.a	3	3
Number of Issuers	3	3	3	3	3	3	3	3	3	3

Issuance (in EUR million)	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Total Covered Bonds Issuance										
Public Sector	-	-	-	-	-	-	-	-	-	-
Mortgage	808	1,418	331	3,331	3,209	542	2,264	1,140	559	91
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Issuance	808	1,418	331	3,331	3,209	542	2,264	1,140	559	91
Public Placement										
Benchmark (1bn and above)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	-	-	-
Benchmark (500Mio - 999Mio)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	510	500	-
Others (below 500Mio)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	630	57	-
Private Placement	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	-	2	91
Total	808	1,418	331	3,331	3,209	542	2,264	1,140	559	91
Denominated in EURO	190	1,007	291	1,407	1,102	300	1,600	510	515	-
Denominated in domestic currency	618	411	40	1,907	2,107	242	565	630	42	91
Denominated in other currencies	-	-	-	17	-	-	99	-	2	-
Total	808	1,418	331	3,331	3,209	542	2,264	1,140	559	91
Issuance fixed coupon	718	1,168	116	2,275	3,200	477	538	630	57	44
Issuance floating coupon	90	250	215	1,056	9	65	1,726	510	502	48
Issuance other	-	-	-	-	-	-	-	-	-	-
Total	808	1,418	331	3,331	3,209	542	2,264	1,140	559	92
Number of New Issuers	-	-	-	-	-	-	-	-	-	-

5.2.15 ICELAND

Outstanding (in EUR million)	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Total Covered Bonds Outstanding										
Public Sector	-	-	-	-	-	-	-	-	-	-
Mortgage	-	467	478	492	685	807	808	893	803	927
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Outstanding	-	467	478	492	685	807	808	893	803	927
Public Placement										
Benchmark (1bn and above)	-	-	-	-	-	-	-	-	-	-
Benchmark (500Mio - 999Mio)	-	-	-	-	-	-	-	-	-	-
Others (below 500Mio)	-	467	478	492	685	807	808	893	803	927
Private Placement	-	-	-	-	-	-	-	-	-	-
Total	-	467	478	492	685	807	808	893	803	927
Denominated in EURO	-	-	-	-	-	-	-	-	-	-
Denominated in domestic currency	-	467	478	492	685	807	808	893	803	927
Denominated in other currencies	-	-	-	-	-	-	-	-	-	-
Total	-	467	478	492	685	807	808	893	803	927
Outstanding fixed coupon	-	-	-	-	-	-	-	15	66	199
Outstanding floating coupon	-	-	-	-	-	-	-	-	-	-
Outstanding other	-	467	478	492	685	807	808	878	737	728
Total	-	467	478	492	685	807	808	893	803	927
Number of Programmes	-	n.a.	n.a.	n.a.	n.a.	n.a.	1	3	4	4
Number of Issuers	-	2	2	1	1	1	1	2	3	3

Issuance (in EUR million)	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Total Covered Bonds Issuance										
Public Sector	-	-	-	-	-	-	-	-	-	-
Mortgage	-	467	-	321	-	-	25	113	51	91
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Issuance	-	467	-	321	-	-	25	113	51	91
Public Placement										
Benchmark (1bn and above)	-	-	-	-	-	-	-	-	-	-
Benchmark (500Mio - 999Mio)	-	-	-	-	-	-	-	-	-	-
Others (below 500Mio)	-	467	-	321	-	-	25	113	51	91
Private Placement	-	-	-	-	-	-	-	-	-	-
Total	-	467	-	321	-	-	25	113	51	91
Denominated in EURO	-	-	-	-	-	-	-	-	-	-
Denominated in domestic currency	-	467	-	321	-	-	25	113	51	91
Denominated in other currencies	-	-	-	-	-	-	-	-	-	-
Total	-	467	-	321	-	-	25	113	51	91
Issuance fixed coupon	-	-	-	-	-	-	-	15	23	35
Issuance floating coupon	-	-	-	-	-	-	-	-	-	-
Issuance other	-	467	-	321	-	-	25	98	28	56
Total	-	467	-	321	-	-	25	113	51	91
Number of New Issuers	-	2	-	-	-	-	-	1	1	-

5.2.16 IRELAND

Outstanding (in EUR million)	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Total Covered Bonds Outstanding										
Public Sector	40,965	49,914	51,204	52,613	50,951	36,492	31,760	27,546	22,154	20,258
Mortgage	4,140	11,900	13,575	23,075	29,725	29,037	30,007	25,099	20,827	18,473
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Outstanding	45,105	61,814	64,779	75,688	80,676	65,529	61,767	52,645	42,981	38,731

Public Placement										
Benchmark (1bn and above)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	26,402	23,079	17,169	13,254
Benchmark (500Mio - 999Mio)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	500	500	2,500	4,611
Others (below 500Mio)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	1,092	868	239	-
Private Placement	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	33,773	28,198	23,073	20,866
Total	45,105	61,814	64,779	75,688	80,676	65,529	61,767	52,645	42,981	38,731

Denominated in EURO	37,452	52,800	52,328	60,056	67,626	54,940	53,054	44,725	36,360	31,987
Denominated in domestic currency	-	-	-	-	-	-	-	-	-	-
Denominated in other currencies	7,654	9,014	12,451	15,632	13,050	10,589	8,713	7,920	6,621	6,743
Total	45,105	61,814	64,779	75,688	80,676	65,529	61,767	52,645	42,981	38,731

Outstanding fixed coupon	40,717	55,832	56,094	48,817	43,717	40,069	35,853	32,658	27,652	26,187
Outstanding floating coupon	2,095	3,028	5,299	23,294	33,607	22,507	22,919	17,008	12,730	10,240
Outstanding other	2,294	2,954	3,386	3,577	3,353	2,953	2,995	2,979	2,598	2,303
Total	45,105	61,814	64,779	75,688	80,676	65,529	61,767	52,645	42,981	38,731

Number of Programmes	3	4	4	5	6	6	6	5	5	5
Number of Issuers	3	4	4	5	6	6	6	5	5	5

Issuance (in EUR million)	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Total Covered Bonds Issuance										
Public Sector	13,576	9,722	9,533	12,665	3,174	60	-	-	25	-
Mortgage	2,000	7,753	1,675	9,506	14,801	6,000	9,290	5,500	3,235	2,535
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Issuance	15,576	17,475	11,208	22,171	17,975	6,060	9,290	5,500	3,260	2,535

Public Placement										
Benchmark (1bn and above)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	1,000	1,000	-
Benchmark (500Mio - 999Mio)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	500	2,000	1,250
Others (below 500Mio)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	-	-	-
Private Placement	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	4,000	260	1,285
Total	15,576	17,475	11,208	22,171	17,975	6,060	9,290	5,500	3,260	2,535

Denominated in EURO	10,663	15,035	6,612	18,741	17,975	6,060	9,290	5,500	3,260	2,535
Denominated in domestic currency	-	-	-	-	-	-	-	-	-	-
Denominated in other currencies	4,914	2,440	4,596	3,430	-	-	-	-	-	-
Total	15,576	17,475	11,208	22,171	17,975	6,060	9,290	5,500	3,260	2,535

Issuance fixed coupon	12,033	15,537	8,183	4,600	4,175	210	-	1,500	3,035	1,385
Issuance floating coupon	1,445	1,101	2,351	17,240	13,750	5,850	9,290	4,000	225	1,150
Issuance other	2,097	837	674	331	50	-	-	-	-	-
Total	15,576	17,475	11,208	22,171	17,975	6,060	9,290	5,500	3,260	2,535

Number of New Issuers	-	1	-	1	1	-	-	-	-	-

5.2.17 ITALY

Outstanding (in EUR million)	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Total Covered Bonds Outstanding										
Public Sector	4,000	8,063	8,063	8,063	9,063	10,092	12,999	10,300	6,945	8,700
Mortgage	-	-	-	6,500	14,000	26,925	50,768	116,405	122,099	122,464
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Outstanding	4,000	8,063	8,063	14,563	23,063	37,017	63,767	126,705	129,044	131,164

Public Placement										
Benchmark (1bn and above)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	37,927	39,602	44,453
Benchmark (500Mio - 999Mio)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	4,450	8,450	8,400
Others (below 500Mio)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	1,783	1,170	140
Private Placement	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	82,544	79,822	78,171
Total	4,000	8,063	8,063	14,563	23,063	37,017	63,767	126,705	129,044	131,164

Denominated in EURO	4,000	8,000	8,000	14,500	23,000	36,925	63,668	126,705	129,044	131,164
Denominated in domestic currency	-	-	-	-	-	-	-	-	-	-
Denominated in other currencies	-	63	63	63	63	92	99	-	-	-
Total	4,000	8,063	8,063	14,563	23,063	37,017	63,767	126,705	129,044	131,164

Outstanding fixed coupon	4,000	8,063	8,063	10,063	15,563	27,100	44,954	50,059	57,724	63,924
Outstanding floating coupon	-	-	-	500	500	2,825	18,814	76,646	71,320	67,240
Outstanding other	-	-	-	4,000	7,000	7,092	-	-	-	-
Total	4,000	8,063	8,063	14,563	23,063	37,017	63,767	126,705	129,044	131,164

Number of Programmes	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	19	21
Number of Issuers	1	1	1	4	7	11	12	13	13	14

Issuance (in EUR million)	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Total Covered Bonds Issuance										
Public Sector	4,000	4,063	-	-	3,000	2,000	5,900	-	4,200	1,000
Mortgage	-	-	-	6,500	7,500	12,925	29,261	70,768	24,520	39,475
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Issuance	4,000	4,063	-	6,500	10,500	14,925	35,161	70,768	28,720	40,475

Public Placement										
Benchmark (1bn and above)	n.a.	n.a.	-	n.a.	n.a.	n.a.	n.a.	6,304	5,250	7,750
Benchmark (500Mio - 999Mio)	n.a.	n.a.	-	n.a.	n.a.	n.a.	n.a.	1,700	3,500	2,750
Others (below 500Mio)	n.a.	n.a.	-	n.a.	n.a.	n.a.	n.a.	-	250	-
Private Placement	n.a.	n.a.	-	n.a.	n.a.	n.a.	n.a.	62,764	19,720	29,975
Total	4,000	4,063	-	6,500	10,500	14,925	35,161	70,768	28,720	40,475

Denominated in EURO	4,000	4,000	-	6,500	10,500	14,925	35,161	70,768	28,720	40,475
Denominated in domestic currency	-	-	-	-	-	-	-	-	-	-
Denominated in other currencies	-	63	-	-	-	-	-	-	-	-
Total	4,000	4,063	-	6,500	10,500	14,925	35,161	70,768	28,720	40,475

Issuance fixed coupon	4,000	4,000	-	2,000	7,500	12,600	18,750	11,013	12,170	10,585
Issuance floating coupon	-	-	-	500	-	2,325	16,411	59,755	16,550	29,890
Issuance other	-	63	-	4,000	3,000	-	-	-	-	-
Total	4,000	4,063	-	6,500	10,500	14,925	35,161	70,768	28,720	40,475

Number of New Issuers	-	-	-	3	3	4	1	1	-	1

5.2.18 LATVIA

Outstanding (in EUR million)	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Total Covered Bonds Outstanding										
Public Sector	-	-	-	-	-	-	-	-	-	-
Mortgage	60	63	90	90	85	63	37	-	-	-
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Outstanding	60	63	90	90	85	63	37	-	-	-
Public Placement										
Benchmark (1bn and above)	-	-	-	-	-	-	-	-	-	-
Benchmark (500Mio - 999Mio)	-	-	-	-	-	-	-	-	-	-
Others (below 500Mio)	60	63	90	90	85	63	37	-	-	-
Private Placement	-	-	-	-	-	-	-	-	-	-
Total	60	63	90	90	85	63	37	-	-	-
Denominated in EURO	-	20	56	69	64	45	25	-	-	-
Denominated in domestic currency	38	34	28	17	17	14	12	-	-	-
Denominated in other currencies	21	8	6	4	4	4	-	-	-	-
Total	60	63	90	90	85	63	37	-	-	-
Outstanding fixed coupon	26	21	15	26	26	27	12	-	-	-
Outstanding floating coupon	34	41	75	64	59	36	25	-	-	-
Outstanding other	-	-	-	-	-	-	-	-	-	-
Total	60	63	90	90	85	63	37	-	-	-
Number of Programmes	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	-	-	-
Number of Issuers	1	4	5	5	5	4	2	-	-	-

Issuance (in EUR million)	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Total Covered Bonds Issuance										
Public Sector	-	-	-	-	-	-	-	-	-	-
Mortgage	4	20	19	25	-	-	-	-	-	-
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Issuance	4	20	19	25	-	-	-	-	-	-
Public Placement										
Benchmark (1bn and above)	-	-	-	-	-	-	-	-	-	-
Benchmark (500Mio - 999Mio)	-	-	-	-	-	-	-	-	-	-
Others (below 500Mio)	4	20	19	25	-	-	-	-	-	-
Private Placement	-	-	-	-	-	-	-	-	-	-
Total	4	20	19	25	-	-	-	-	-	-
Denominated in EURO	-	20	19	25	-	-	-	-	-	-
Denominated in domestic currency	4	-	-	-	-	-	-	-	-	-
Denominated in other currencies		-	-	-	-	-	-	-	-	-
Total	4	20	19	25	-	-	-	-	-	-
Issuance fixed coupon	-	-	-	25	-	-	-	-	-	-
Issuance floating coupon	4	20	19	-	-	-	-	-	-	-
Issuance other	-	-	-	-	-	-	-	-	-	-
Total	4	20	19	25	-	-	-	-	-	-
Number of New Issuers	-	3	1	-	-	-	-	-	-	-

5.2.19 LUXEMBOURG

Outstanding (in EUR million)	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Total Covered Bonds Outstanding										
Public Sector	24,968	28,360	33,741	35,467	31,645	28,889	26,700	24,859	21,708	16,002
Mortgage	-	150	150	150	-	-	-	-	-	-
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Outstanding	24,968	28,510	33,891	35,617	31,645	28,889	26,700	24,859	21,708	16,002
Public Placement										
Benchmark (1bn and above)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	1,768	1,000	-
Benchmark (500Mio - 999Mio)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	-	-	973
Others (below 500Mio)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	9,696	10,052	8,041
Private Placement	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	13,395	10,656	6,987
Total	24,968	28,510	33,891	35,617	31,645	28,889	26,700	24,859	21,708	16,002
Denominated in EURO	10,909	12,319	16,172	18,147	16,592	15,826	15,496	14,994	12,925	8,226
Denominated in domestic currency	-	-	-	-	-	-	-	-	-	-
Denominated in other currencies	14,059	16,191	17,719	17,470	15,053	13,063	11,204	9,864	8,783	7,775
Total	24,968	28,510	33,891	35,617	31,645	28,889	26,700	24,859	21,708	16,002
Outstanding fixed coupon	15,427	19,077	22,573	22,267	21,126	20,390	16,547	14,766	13,182	11,417
Outstanding floating coupon	7,376	7,217	9,210	11,270	9,355	7,710	9,377	8,507	7,080	3,802
Outstanding other	2,165	2,216	2,108	2,080	1,164	789	776	1,585	1,445	783
Total	24,968	28,510	33,891	35,617	31,645	28,889	26,700	24,859	21,708	16,002
Number of Programmes	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	6	5
Number of Issuers	3	3	5	5	5	5	5	6	6	5

Issuance (in EUR million)	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Total Covered Bonds Issuance										
Public Sector	9,611	9,730	10,052	3,967	3,083	3,524	2,788	2,660	825	398
Mortgage	-	150	-	-	-	-	-	-	-	-
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Issuance	9,611	9,880	10,052	3,967	3,083	3,524	2,788	2,660	825	398
Public Placement										
Benchmark (1bn and above)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	-	-	-
Benchmark (500Mio - 999Mio)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	-	-	-
Others (below 500Mio)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	-	-	-
Private Placement	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	2,660	825	398
Total	9,611	9,880	10,052	3,967	3,083	3,524	2,788	2,660	825	398
Denominated in EURO	2,468	3,628	5,773	2,639	2,661	3,260	2,422	2,587	825	233
Denominated in domestic currency	-	-	-	-	-	-	-	-	-	-
Denominated in other currencies	7,143	6,252	4,279	1,328	422	264	366	73	-	165
Total	9,611	9,880	10,052	3,967	3,083	3,524	2,788	2,660	825	398
Issuance fixed coupon	7,511	8,092	5,425	1,423	1,526	1,213	336	187	-	398
Issuance floating coupon	1,700	1,601	4,448	2,471	1,530	2,289	2,452	2,473	825	-
Issuance other	400	187	178	73	27	22	-	-	-	-
Total	9,611	9,880	10,051	3,967	3,083	3,524	2,788	2,660	825	398
Number of New Issuers	-	-	2	-	-	-	-	1	-	-

5.2.20 THE NETHERLANDS

Outstanding (in EUR million)	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**
Total Covered Bonds Outstanding										
Public Sector	-	-	-	-	-	-	-	-	-	-
Mortgage	2,000	7,477	15,093	20,534	27,664	40,180	51,970	59,822	61,015	58,850
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Outstanding	2,000	7,477	15,093	20,534	27,664	40,180	51,970	59,822	61,015	58,850
Public Placement										
Benchmark (1bn and above)	2,000	5,500	11,000	14,275	20,650	29,898	39,623	45,245	44,913	41,159
Benchmark (500Mio - 999Mio)	-	-	-	-	-	-	500	500	1,000	1,000
Others (below 500Mio)	-	685	937	1,279	1,281	1,819	2,345	2,319	2,281	2,329
Private Placement	-	1,292	3,156	4,979	5,733	8,463	9,503	11,758	12,822	14,362
Total	2,000	7,477	15,093	20,534	27,664	40,180	51,970	59,822	61,015	58,850
Denominated in EURO	2,000	6,437	13,777	18,715	25,822	36,854	47,795	53,884	55,362	53,030
Denominated in domestic currency	-	-	-	-	-	-	-	-	-	-
Denominated in other currencies	-	1,040	1,316	1,819	1,842	3,326	4,175	5,938	5,653	5,820
Total	2,000	7,477	15,093	20,534	27,664	40,180	51,970	59,822	61,015	58,850
Outstanding fixed coupon	2,000	7,182	13,697	17,804	25,658	37,954	51,230	58,902	60,016	57,892
Outstanding floating coupon	-	255	1,336	2,670	1,956	2,176	700	880	959	928
Outstanding other	-	40	60	60	50	50	40	40	40	30
Total	2,000	7,477	15,093	20,534	27,664	40,180	51,970	59,822	61,015	58,850
Number of Programmes	1	1	2	5	5	5	5	5	6	5
Number of Issuers	1	1	2	5	5	5	5	5	5	5

Issuance (in EUR million)	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**
Total Covered Bonds Issuance										
Public Sector	-	-	-	-	-	-	-	-	-	-
Mortgage	2,000	5,477	7,648	5,355	7,725	13,660	14,143	10,738	4,478	3,910
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Issuance	2,000	5,477	7,648	5,355	7,725	13,660	14,143	10,738	4,478	3,910
Public Placement										
Benchmark (1bn and above)	2,000	3,500	5,500	3,275	6,375	10,498	9,700	8,387	2,750	1,500
Benchmark (500Mio - 999Mio)	-	-	-	-	-	-	500	-	500	500
Others (below 500Mio)	-	685	272	236	-	300	473	290	-	-
Private Placement	-	1,292	1,876	1,845	1,350	2,862	3,470	2,062	1,228	1,910
Total	2,000	5,477	7,648	5,355	7,725	13,660	14,143	10,738	4,478	3,910
Denominated in EURO	2,000	4,437	7,340	4,938	7,725	12,337	13,207	8,859	4,478	3,910
Denominated in domestic currency	-	-	-	-	-	-	-	-	-	-
Denominated in other currencies	-	1,040	308	418	-	1,324	937	1,879	-	-
Total	2,000	5,477	7,648	5,355	7,725	13,660	14,143	10,738	4,478	3,910
Issuance fixed coupon	2,000	5,182	6,529	4,030	7,725	13,603	14,013	10,558	4,398	3,895
Issuance floating coupon	-	255	1,099	1,325	-	57	130	180	80	15
Issuance other	-	40	20	-	-	-	-	-	-	-
Total	2,000	5,477	7,648	5,355	7,725	13,660	14,143	10,738	4,478	3,910
Number of New Issuers	1	-	1	3	-	-	-	-	-	-

5.2.21 NEW ZEALAND

Outstanding (in EUR million)	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Total Covered Bonds Outstanding										
Public Sector	-	-	-	-	-	-	-	-	-	-
Mortgage	-	-	-	-	-	1,247	3,656	6,881	7,851	9,464
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Outstanding	-	-	-	-	-	1,247	3,656	6,881	7,851	9,464
Public Placement										
Benchmark (1bn and above)	-	-	-	-	-	1,000	2,000	2,000	2,000	2,000
Benchmark (500Mio - 999Mio)	-	-	-	-	-	-	1,050	3,051	3,954	5,472
Others (below 500Mio)	-	-	-	-	-	247	427	1,353	1,436	1,992
Private Placement	-	-	-	-	-	-	179	477	461	-
Total	-	-	-	-	-	1,247	3,656	6,881	7,851	9,464
Denominated in EURO	-	-	-	-	-	1,000	2,500	4,500	5,500	7,000
Denominated in domestic currency	-	-	-	-	-	247	606	982	940	1,014
Denominated in other currencies	-	-	-	-	-	-	550	1,399	1,411	1,449
Total	-	-	-	-	-	1,247	3,656	6,881	7,851	9,464
Outstanding fixed coupon	-	-	-	-	-	1,247	3,477	6,259	7,244	8,834
Outstanding floating coupon	-	-	-	-	-	-	179	622	607	630
Outstanding other	-	-	-	-	-	-	-	-	-	-
Total	-	-	-	-	-	1,247	3,656	6,881	7,851	9,464
Number of Programmes	-	-	-	-	-	1	4	4	5	5
Number of Issuers	-	-	-	-	-	1	4	4	5	5

Issuance (in EUR million)	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Total Covered Bonds Issuance										
Public Sector	-	-	-	-	-	-	-	-	-	-
Mortgage	-	-	-	-	-	1,247	2,409	3,192	1,122	750
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Issuance	-	-	-	-	-	1,247	2,409	3,192	1,122	750
Public Placement										
Benchmark (1bn and above)	-	-	-	-	-	1,000	1,000	-	-	-
Benchmark (500Mio - 999Mio)	-	-	-	-	-	-	1,050	2,000	1,000	750
Others (below 500Mio)	-	-	-	-	-	247	179	902	122	-
Private Placement	-	-	-	-	-	-	179	290	-	-
Total	-	-	-	-	-	1,247	2,409	3,192	1,122	750
Denominated in EURO	-	-	-	-	-	1,000	1,500	2,000	1,000	750
Denominated in domestic currency	-	-	-	-	-	247	358	343	-	-
Denominated in other currencies	-	-	-	-	-	-	550	849	122	-
Total	-	-	-	-	-	1,247	2,409	3,192	1,122	750
Issuance fixed coupon	-	-	-	-	-	1,247	2,229	2,757	1,122	750
Issuance floating coupon	-	-	-	-	-	-	179	435	-	-
Issuance other	-	-	-	-	-	-	-	-	-	-
Total	-	-	-	-	-	1,247	2,409	3,192	1,122	750
Number of New Issuers	-	-	-	-	-	1	3	-	1	-

5.2.22 NORWAY

Outstanding (in EUR million)	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Total Covered Bonds Outstanding										
Public Sector	-	-	-	-	751	1,837	3,759	2,742	2,035	1,820
Mortgage	-	-	6,371	21,924	53,582	70,401	91,852	107,242	105,202	102,704
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Outstanding	-	-	6,371	21,924	54,333	72,238	95,611	109,984	107,237	104,524
Public Placement										
Benchmark (1bn and above)	-	-	n.a.	n.a.	n.a.	n.a.	n.a.	51,179	47,342	51,185
Benchmark (500Mio - 999Mio)	-	-	n.a.	n.a.	n.a.	n.a.	n.a.	20,125	18,471	14,523
Others (below 500Mio)	-	-	n.a.	n.a.	n.a.	n.a.	n.a.	32,354	31,763	26,434
Private Placement	-	-	n.a.	n.a.	n.a.	n.a.	n.a.	6,327	9,661	12,382
Total	-	-	6,371	21,924	54,333	72,238	95,611	109,985	107,237	104,524
Denominated in EURO	-	-	4,500	12,847	14,522	22,022	29,953	38,597	44,510	49,928
Denominated in domestic currency	-	-	1,433	8,351	39,022	45,803	55,325	59,533	49,965	41,502
Denominated in other currencies	-	-	438	725	789	4,413	10,333	11,854	12,762	13,094
Total	-	-	6,371	21,924	54,333	72,238	95,611	109,984	107,237	104,524
Outstanding fixed coupon	-	-	5,718	14,750	17,064	28,809	44,813	56,918	63,088	66,831
Outstanding floating coupon	-	-	653	7,174	37,269	43,429	50,798	53,066	44,148	37,694
Outstanding other	-	-	-	-	-	-	-	-	-	-
Total	-	-	6,371	21,924	54,333	72,238	95,611	109,984	107,236	104,524
Number of Programmes	-	-	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	23	23
Number of Issuers	-	-	3	7	22	22	23	22	22	22

Issuance (in EUR million)	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Total Covered Bonds Issuance										
Public Sector	-	-	-	-	751	1,421	2,374	943	239	664
Mortgage	-	-	6,458	15,660	30,105	21,062	28,135	22,946	18,339	14,474
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Issuance	-	-	6,458	15,660	30,856	22,483	30,509	23,888	18,578	15,138
Public Placement										
Benchmark (1bn and above)	-	-	n.a.	n.a.	n.a.	n.a.	n.a.	10,916	7,441	6,823
Benchmark (500Mio - 999Mio)	-	-	n.a.	n.a.	n.a.	n.a.	n.a.	4,748	1,458	2,157
Others (below 500Mio)	-	-	n.a.	n.a.	n.a.	n.a.	n.a.	7,664	8,267	5,082
Private Placement	-	-	n.a.	n.a.	n.a.	n.a.	n.a.	560	1,412	1,076
Total	-	-	6,458	15,660	30,856	22,483	30,509	23,888	18,578	15,138
Denominated in EURO	-	-	4,500	8,346	2,044	11,232	8,800	12,431	8,382	4,590
Denominated in domestic currency	-	-	1,521	7,042	28,745	7,777	15,808	9,463	7,546	9,854
Denominated in other currencies	-	-	438	272	67	3,474	5,901	1,994	2,651	694
Total	-	-	6,458	15,660	30,856	22,483	30,509	23,888	18,578	15,138
Issuance fixed coupon	-	-	5,754	9,020	2,207	16,074	15,961	15,462	11,423	3,475
Issuance floating coupon	-	-	704	6,640	28,649	6,409	14,548	8,427	7,155	11,519
Issuance other	-	-	-	-	-	-	-	-	-	144
Total	-	-	6,458	15,660	30,856	22,483	30,509	23,888	18,578	15,138
Number of New Issuers	-	-	3	4	15	-	1	-	-	1

5.2.23 PANAMA

Outstanding (in EUR million)	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Total Covered Bonds Outstanding										
Public Sector	-	-	-	-	-	-	-	-	-	-
Mortgage	-	-	-	-	-	-	-	152	218	247
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Outstanding	-	-	-	-	-	-	-	152	218	247
Public Placement										
Benchmark (1bn and above)	-	-	-	-	-	-	-	-	-	-
Benchmark (500Mio - 999Mio)	-	-	-	-	-	-	-	-	-	-
Others (below 500Mio)	-	-	-	-	-	-	-	152	218	247
Private Placement	-	-	-	-	-	-	-	-	-	-
Total	-	-	-	-	-	-	-	152	218	247
Denominated in EURO	-	-	-	-	-	-	-	-	-	-
Denominated in domestic currency	-	-	-	-	-	-	-	-	-	-
Denominated in other currencies	-	-	-	-	-	-	-	152	218	247
Total	-	-	-	-	-	-	-	152	218	247
Outstanding fixed coupon	-	-	-	-	-	-	-	152	218	247
Outstanding floating coupon	-	-	-	-	-	-	-	-	-	-
Outstanding other	-	-	-	-	-	-	-	-	-	-
Total	-	-	-	-	-	-	-	152	218	247
Number of Programmes	-	-	-	-	-	-	-	1	1	1
Number of Issuers	-	-	-	-	-	-	-	1	1	1

Issuance (in EUR million)	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Total Covered Bonds Issuance										
Public Sector	-	-	-	-	-	-	-	-	-	-
Mortgage	-	-	-	-	-	-	-	152	73	-
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Issuance	-	-	-	-	-	-	-	152	73	-
Public Placement										
Benchmark (1bn and above)	-	-	-	-	-	-	-	-	-	-
Benchmark (500Mio - 999Mio)	-	-	-	-	-	-	-	-	-	-
Others (below 500Mio)	-	-	-	-	-	-	-	152	73	-
Private Placement	-	-	-	-	-	-	-	-	-	-
Total	-	-	-	-	-	-	-	152	73	-
Denominated in EURO	-	-	-	-	-	-	-	-	-	-
Denominated in domestic currency	-	-	-	-	-	-	-	-	-	-
Denominated in other currencies	-	-	-	-	-	-	-	152	73	-
Total	-	-	-	-	-	-	-	152	73	-
Issuance fixed coupon	-	-	-	-	-	-	-	152	73	-
Issuance floating coupon	-	-	-	-	-	-	-	-	-	-
Issuance other	-	-	-	-	-	-	-	-	-	-
Total	-	-	-	-	-	-	-	152	73	-
Number of New Issuers	-	-	-	-	-	-	-	1	-	-

5.2.24 POLAND

Outstanding (in EUR million)	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Total Covered Bonds Outstanding										
Public Sector	-	-	131	137	139	126	112	110	84	82
Mortgage	558	453	676	561	583	511	527	657	707	882
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Outstanding	558	453	807	698	722	636	639	768	791	964
Public Placement										
Benchmark (1bn and above)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	-	-	-
Benchmark (500Mio - 999Mio)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	-	-	-
Others (below 500Mio)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	768	791	964
Private Placement	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	-	-	-
Total	558	453	807	698	722	636	639	768	791	964
Denominated in EURO	62	62	56	56	4	-	-	20	117	250
Denominated in domestic currency	440	357	726	617	711	636	639	748	674	714
Denominated in other currencies	56	34	25	25	7	-	-	-	-	-
Total	558	453	807	698	722	636	639	768	791	964
Outstanding fixed coupon	4	4	1	1	4	-	-	-	30	107
Outstanding floating coupon	554	450	806	697	718	636	639	768	761	857
Outstanding other	-	-	-	-	-	-	-	-	-	-
Total	558	453	807	698	722	636	639	768	791	964
Number of Programmes	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	3	3	3
Number of Issuers	2	2	2	3	3	3	2	2	2	2

Issuance (in EUR million)	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Total Covered Bonds Issuance										
Public Sector	-	-	131	24	-	25	-	61	-	-
Mortgage	224	52	206	197	88	138	269	228	116	269
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Issuance	224	52	337	222	88	164	269	289	116	269
Public Placement										
Benchmark (1bn and above)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	-	-	-
Benchmark (500Mio - 999Mio)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	-	-	-
Others (below 500Mio)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	289	116	269
Private Placement	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	-	-	-
Total	224	52	337	222	88	164	269	289	116	269
Denominated in EURO	-	-	-	-	-	-	-	20	96	135
Denominated in domestic currency	211	52	337	222	88	164	269	269	20	135
Denominated in other currencies	12	-	-	-	-	-	-	-	-	-
Total	223	52	337	222	88	164	269	289	116	269
Issuance fixed coupon	-	-	-	-	-	-	-	-	30	78
Issuance floating coupon	224	52	337	222	88	164	269	289	86	192
Issuance other	-	-	-	-	-	-	-	-	-	-
Total	224	52	337	222	88	164	269	289	116	269

Number of New Issuers	1	-	-	1	-	-	-	-	-	-

5.2.25 PORTUGAL

Outstanding (in EUR million)	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Total Covered Bonds Outstanding										
Public Sector	-	-	-	150	1,150	1,400	1,400	1,300	1,200	400
Mortgage	-	2,000	7,850	15,270	20,270	27,690	33,248	34,321	36,016	33,711
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Outstanding	-	2,000	7,850	15,420	21,420	29,090	34,648	35,621	37,216	34,111
Public Placement										
Benchmark (1bn and above)	-	2,000	6,500	12,150	18,150	17,900	15,358	11,550	9,706	8,656
Benchmark (500Mio - 999Mio)	-	-	-	-	-	-	-	-	750	1,500
Others (below 500Mio)	-	-	-	-	-	-	-	-	-	-
Private Placement	-	-	1,350	3,270	3,270	11,190	19,290	24,071	26,760	23,955
Total	-	2,000	7,850	15,420	21,420	29,090	34,648	35,621	37,216	34,111
Denominated in EURO	-	2,000	7,850	15,420	21,420	29,090	34,648	35,621	37,216	34,111
Denominated in domestic currency	-	-	-	-	-	-	-	-	-	-
Denominated in other currencies	-	-	-	-	-	-	-	-	-	-
Total	-	2,000	7,850	15,420	21,420	29,090	34,648	35,621	37,216	34,111
Outstanding fixed coupon	-	2,000	6,500	12,170	18,170	17,960	15,418	11,610	10,516	10,966
Outstanding floating coupon	-	-	1,350	3,250	3,250	11,130	19,230	24,011	26,700	23,145
Outstanding other	-	-	-	-	-	-	-	-	-	-
Total	-	2,000	7,850	15,420	21,420	29,090	34,648	35,621	37,216	34,111
Number of Programmes	-	1	2	6	8	9	11	11	11	10
Number of Issuers	-	1	2	5	6	7	9	9	9	9

Issuance (in EUR million)	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Total Covered Bonds Issuance										
Public Sector	-	-	-	150	1,000	250	-	-	-	-
Mortgage	-	2,000	5,850	7,420	6,000	11,570	8,450	4,850	4,500	3,825
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Issuance	-	2,000	5,850	7,570	7,000	11,820	8,450	4,850	4,500	3,825
Public Placement										
Benchmark (1bn and above)	-	2,000	4,500	5,650	6,000	3,000	-	-	-	1,000
Benchmark (500Mio - 999Mio)	-	-	-	-	-	-	-	-	750	1,500
Others (below 500Mio)	-	-	-	-	-	-	-	-	-	-
Private Placement	-	-	1,350	1,920	1,000	8,820	8,450	4,850	3,750	1,325
Total	-	2,000	5,850	7,570	7,000	11,820	8,450	4,850	4,500	3,825
Denominated in EURO	-	2,000	5,850	7,570	7,000	11,820	8,450	4,850	4,500	3,825
Denominated in domestic currency	-	-	-	-	-	-	-	-	-	-
Denominated in other currencies	-	-	-	-	-	-	-	-	-	-
Total	-	2,000	5,850	7,570	7,000	11,820	8,450	4,850	4,500	3,825
Issuance fixed coupon	-	2,000	4,500	5,650	6,000	3,040	-	-	750	3,250
Issuance floating coupon	-	-	1,350	1,920	1,000	8,780	8,450	4,850	3,750	575
Issuance other	-	-	-	-	-	-	-	-	-	-
Total	-	2,000	5,850	7,570	7,000	11,820	8,450	4,850	4,500	3,825
Number of New Issuers	-	1	1	3	1	1	2	-	-	-

5.2.26 SLOVAKIA

Outstanding (in EUR million)	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Total Covered Bonds Outstanding										
Public Sector	-	-	-	-	-	-	-	-	-	-
Mortgage	1,583	2,214	2,738	3,576	3,608	3,442	3,768	3,835	4,067	3,939
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Outstanding	1,583	2,214	2,738	3,576	3,608	3,442	3,768	3,835	4,067	3,939

Public Placement										
Benchmark (1bn and above)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	-	-	-
Benchmark (500Mio - 999Mio)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	-	-	-
Others (below 500Mio)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	1,606	1,477	1,197
Private Placement	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	2,229	2,590	2,742
Total	1,583	2,214	2,738	3,576	3,608	3,442	3,768	3,835	4,067	3,939

Denominated in EURO	-	280	510	1,189	3,516	3,350	3,625	3,680	3,925	3,814
Denominated in domestic currency	1,583	1,934	2,161	2,296	-	-	-	-	-	-
Denominated in other currencies	-	-	68	92	92	92	143	155	142	124
Total	1,583	2,214	2,738	3,576	3,608	3,442	3,768	3,835	4,067	3,939

Outstanding fixed coupon	1,223	1,405	1,666	1,992	1,845	1,571	1,886	2,224	2,611	2,754
Outstanding floating coupon	360	809	1,073	1,584	1,762	1,871	1,882	1,606	1,451	1,185
Outstanding other	-	-	-	-	-	-	-	5	5	-
Total	1,583	2,214	2,738	3,576	3,608	3,442	3,768	3,835	4,067	3,939

Number of Programmes	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	8	8
Number of Issuers	9	9	8	8	8	8	8	8	8	8

Issuance (in EUR million)	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Total Covered Bonds Issuance										
Public Sector	-	-	-	-	-	-	-	-	-	-
Mortgage	584	676	803	1,414	707	1,179	867	785	841	654
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Issuance	584	676	803	1,414	707	1,179	867	785	841	654

Public Placement										
Benchmark (1bn and above)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	-	-	-
Benchmark (500Mio - 999Mio)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	-	-	-
Others (below 500Mio)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	248	167	154
Private Placement	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	537	674	500
Total	584	676	803	1,414	707	1,179	867	785	841	654

Denominated in EURO	-	280	230	679	707	1,179	820	735	815	654
Denominated in domestic currency	584	396	505	711	-	-	-	-	-	-
Denominated in other currencies	-	-	68	24	-	-	47	50	26	-
Total	584	676	803	1,414	707	1,179	867	785	841	654

Issuance fixed coupon	223	227	539	902	529	349	414	703	757	585
Issuance floating coupon	360	449	264	512	178	830	452	77	84	69
Issuance other	-	-	-	-	-	-	-	5	-	-
Total	584	676	803	1,414	707	1,179	867	785	841	654

Number of New Issuers	1	-	-	-	-	-	-	-	-	-

5.2.27 SOUTH KOREA

Outstanding (in EUR million)	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Total Covered Bonds Outstanding										
Public Sector	-	-	-	-	-	-	-	-	-	-
Mortgage	-	-	-	-	773	1,120	2,171	2,407	2,536	1,349
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Outstanding	-	-	-	-	773	1,120	2,171	2,407	2,536	1,349
Public Placement										
Benchmark (1bn and above)	-	-	-	-	773	773	773	758	725	-
Benchmark (500Mio - 999Mio)	-	-	-	-	-	347	721	758	1,088	1,235
Others (below 500Mio)	-	-	-	-	-	-	-	-	-	-
Private Placement	-	-	-	-	-	-	677	891	723	113
Total	-	-	-	-	773	1,120	2,171	2,407	2,536	1,349
Denominated in EURO	-	-	-	-	-	-	-	-	-	-
Denominated in domestic currency	-	-	-	-	-	-	527	740	723	113
Denominated in other currencies	-	-	-	-	773	1,120	1,644	1,667	1,813	1,235
Total	-	-	-	-	773	1,120	2,171	2,407	2,536	1,349
Outstanding fixed coupon	-	-	-	-	773	1,120	2,021	2,255	2,536	1,349
Outstanding floating coupon	-	-	-	-	-	-	150	152	-	-
Outstanding other	-	-	-	-	-	-	-	-	-	-
Total	-	-	-	-	773	1,120	2,171	2,407	2,536	1,349
Number of Programmes	-	-	-	-	1	2	2	2	2	1
Number of Issuers	-	-	-	-	1	2	2	2	2	1

Issuance (in EUR million)	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Total Covered Bonds Issuance										
Public Sector	-	-	-	-	-	-	-	-	-	-
Mortgage	-	-	-	-	773	347	1,051	178	466	-
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Issuance	-	-	-	-	773	347	1,051	178	466	-
Public Placement										
Benchmark (1bn and above)	-	-	-	-	773	-	-	-	-	-
Benchmark (500Mio - 999Mio)	-	-	-	-	-	347	374	-	363	-
Others (below 500Mio)	-	-	-	-	-	-	-	-	-	-
Private Placement	-	-	-	-	-	-	677	178	103	-
Total	-	-	-	-	773	347	1,051	178	466	-
Denominated in EURO	-	-	-	-	-	-	-	-	-	-
Denominated in domestic currency	-	-	-	-	-	-	527	178	466	-
Denominated in other currencies	-	-	-	-	773	347	524	-	-	-
Total	-	-	-	-	773	347	1,051	178	466	-
Issuance fixed coupon	-	-	-	-	773	347	901	178	466	-
Issuance floating coupon	-	-	-	-	-	-	150	-	-	-
Issuance other	-	-	-	-	-	-	-	-	-	-
Total	-	-	-	-	773	347	1,051	178	466	-
Number of New Issuers	-	-	-	-	1	1	-	-	-	-

5.2.28 SPAIN

Outstanding (in EUR million)	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Total Covered Bonds Outstanding										
Public Sector	9,640	11,590	17,054	17,749	16,724	19,098	32,657	33,609	30,352	25,495
Mortgage	150,213	214,768	266,959	315,055	336,750	343,401	369,208	406,736	334,572	282,568
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Outstanding	159,853	226,358	284,013	332,804	353,474	362,499	401,865	440,345	364,924	308,063
Public Placement										
Benchmark (1bn and above)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	243,207	211,343	172,344
Benchmark (500Mio - 999Mio)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	11,850	14,098	10,714
Others (below 500Mio)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	200	-	-
Private Placement	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	185,088	139,483	125,006
Total	159,853	226,358	284,013	332,804	353,474	362,499	401,865	440,345	364,924	308,063
Denominated in EURO	159,853	226,358	283,334	332,085	352,780	361,751	401,092	438,641	363,731	306,522
Denominated in domestic currency	-	-	-	-	-	-	-	-	-	-
Denominated in other currencies	-	-	679	719	694	748	773	1,703	1,193	1,541
Total	159,853	226,358	284,013	332,804	353,474	362,499	401,865	440,345	364,924	308,063
Outstanding fixed coupon	153,588	212,878	238,952	262,198	291,929	310,499	343,067	311,719	260,831	200,975
Outstanding floating coupon	6,265	13,480	45,061	70,606	61,545	52,000	58,797	128,625	103,631	107,088
Outstanding other	-	-	-	-	-	-	-	-	462	-
Total	159,853	226,358	284,013	332,804	353,474	362,499	401,865	440,345	364,924	308,063
Number of Programmes	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	40	39
Number of Issuers	65	67	69	66	68	59	64	38	32	31

Issuance (in EUR million)	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Total Covered Bonds Issuance										
Public Sector	2,440	5,150	5,739	1,670	500	5,900	20,334	6,407	5,895	1,853
Mortgage	57,780	69,890	51,801	54,187	43,580	51,916	72,077	98,846	22,919	23,038
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Issuance	60,220	75,040	57,540	55,857	44,080	57,816	92,411	105,253	28,814	24,891
Public Placement										
Benchmark (1bn and above)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	7,200	7,000	8,250
Benchmark (500Mio - 999Mio)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	3,600	4,840	500
Others (below 500Mio)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	-	-	-
Private Placement	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	94,453	16,974	16,141
Total	60,220	75,040	57,540	55,857	44,080	57,816	92,411	105,253	28,814	24,891
Denominated in EURO	60,220	75,040	56,861	55,857	44,080	57,816	92,411	105,253	28,814	24,891
Denominated in domestic currency	-	-	-	-	-	-	-	-	-	-
Denominated in other currencies	-	-	679	-	-	-	-	-	-	-
Total	60,220	75,040	57,540	55,857	44,080	57,816	92,411	105,253	28,814	24,891
Issuance fixed coupon	55,545	66,125	36,549	21,957	37,480	50,891	52,507	27,559	16,169	8,800
Issuance floating coupon	4,675	8,915	20,991	33,900	6,600	6,925	39,904	77,694	12,445	16,091
Issuance other	-	-	-	-	-	-	-	-	200	-
Total	60,220	75,040	57,540	55,857	44,080	57,816	92,411	105,253	28,814	24,891
Number of New Issuers	7	1	1	1	1	2	1	3	-	-

Source: AIAF, Bloomberg, Reuters, Moody's, Fitch, S&P, ECBC

Note: Please note that the breakdown public vs private placements is an estimation made by the ECBC.

Please also note that the methodology used for counting the number of issuers has changed. Until 2011, the number of "new issuers" included the new financial institutions established as part of the restructuring of the Spanish banking sector whose inaugural issue occurred during the year of reporting. The number of issuers also included all the former financial institutions with outstanding covered bonds at the end of each year – even if, as a consequence of the aforementioned restructuring, they were integrated into a new one – along with the new institutions. From 2012 onwards, however, only the new entities are reported as active issuers.

5.2.29 SWEDEN

Outstanding (in EUR million)	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Total Covered Bonds Outstanding										
Public Sector	n.a.	-	-	-	-	-	-	-	-	-
Mortgage	n.a.	55,267	92,254	117,628	133,903	188,750	208,894	220,374	217,854	209,842
Ships	n.a.	-	-	-	-	-	-	-	-	-
Others	n.a.	-	-	-	-	-	-	-	-	-
Total Outstanding	n.a.	55,267	92,254	117,628	133,903	188,750	208,894	220,374	217,854	209,842
Public Placement										
Benchmark (1bn and above)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	175,163	173,333	163,281
Benchmark (500Mio - 999Mio)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	8,234	10,775	12,149
Others (below 500Mio)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	29,055	26,071	26,047
Private Placement	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	7,921	7,676	8,364
Total	n.a.	55,267	92,254	117,628	133,903	188,750	208,894	220,374	217,854	209,842
Denominated in EURO	n.a.	5,283	13,171	21,126	25,787	35,697	37,554	39,995	39,423	36,108
Denominated in domestic currency	n.a.	49,474	77,436	93,374	103,809	144,969	159,628	164,501	161,651	156,791
Denominated in other currencies	n.a.	510	1,648	3,128	4,308	8,085	11,712	15,878	16,780	16,942
Total	n.a.	55,267	92,254	117,628	133,903	188,750	208,894	220,374	217,854	209,842
Outstanding fixed coupon	n.a.	55,029	88,944	112,648	126,116	172,693	191,013	198,372	195,770	187,395
Outstanding floating coupon	n.a.	21	3,046	4,259	7,169	16,013	17,659	21,778	22,055	22,432
Outstanding other	n.a.	217	265	721	619	45	222	224	29	14
Total	n.a.	55,267	92,254	117,628	133,903	188,750	208,894	220,374	217,854	209,842
Number of Programmes	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	10	10
Number of Issuers	n.a.	3	6	7	7	7	7	7	8	8

Issuance (in EUR million)	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Total Covered Bonds Issuance										
Public Sector	n.a.	-	-	-	-	-	-	-	-	-
Mortgage	n.a.	17,569	36,638	43,488	53,106	79,910	69,800	48,936	51,633	48,424
Ships	n.a.	-	-	-	-	-	-	-	-	-
Others	n.a.	-	-	-	-	-	-	-	-	-
Total Issuance	n.a.	17,569	36,638	43,488	53,106	79,910	69,800	48,936	51,633	48,424
Public Placement										
Benchmark (1bn and above)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	37,148	35,519	34,881
Benchmark (500Mio - 999Mio)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	92	6,753	5,989
Others (below 500Mio)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	10,078	8,276	5,883
Private Placement	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	1,620	1,086	1,672
Total	n.a.	17,569	36,638	43,488	53,106	79,910	69,800	48,936	51,633	48,424
Denominated in EURO	n.a.	5,283	7,085	10,975	6,705	20,797	13,263	2,485	5,745	6,531
Denominated in domestic currency	n.a.	11,794	28,417	31,490	44,354	55,117	52,118	41,971	41,220	39,866
Denominated in other currencies	n.a.	492	1,135	1,023	2,047	3,997	4,419	4,481	4,668	2,027
Total	n.a.	17,569	36,638	43,488	53,106	79,910	69,800	48,936	51,633	48,424
Issuance fixed coupon	n.a.	17,560	35,779	39,135	47,375	68,023	53,137	38,294	42,949	41,346
Issuance floating coupon	n.a.	2	752	4,353	5,376	11,888	16,562	10,642	8,684	7,077
Issuance other	n.a.	7	107	-	354	-	102	-	-	-
Total	n.a.	17,569	36,638	43,488	53,106	79,910	69,800	48,936	51,633	48,424
Number of New Issuers	n.a.	3	3	1	-	-	-	-	1	-

5.2.30 SWITZERLAND

Outstanding (in EUR million)	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Total Covered Bonds Outstanding										
Outstanding CBs - Pfandbriefe	29,010	29,395	29,013	36,180	43,283	58,046	60,729	67,652	71,716	78,468
Outstanding CBs - Structured	-	-	-	-	3,000	7,000	11,152	18,055	17,348	21,967
Total Outstanding	29,010	29,395	29,013	36,180	46,283	65,046	71,881	85,707	89,064	100,436

Public Placement										
Benchmark (1bn and above)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	17,926	17,120	21,133
Benchmark (500Mio - 999Mio)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	23,839	6,218	40,767
Others (below 500Mio)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	35,986	61,351	37,701
Private Placement	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	7,956	4,376	834
Total	29,010	29,395	29,013	36,180	46,283	65,046	71,881	85,707	89,064	100,436

Denominated in EURO	-	-	-	-	3,000	7,000	10,250	13,000	11,500	15,350
Denominated in domestic currency	29,010	29,395	29,013	36,180	43,283	58,046	60,729	67,652	71,716	78,468
Denominated in other currencies	-	-	-	-	-	-	902	5,055	5,848	6,617
Total	29,010	29,395	29,013	36,180	46,283	65,046	71,881	85,707	89,064	100,436

Outstanding fixed coupon	29,010	29,395	29,013	36,180	46,283	65,046	71,752	85,707	89,064	100,312
Outstanding floating coupon	-	-	-	-	-	-	-	-	-	124
Outstanding other	-	-	-	-	-	-	129	-	-	-
Total	29,010	29,395	29,013	36,180	46,283	65,046	71,881	85,707	89,064	100,436

Number of Programmes	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	4	4
Number of Issuers	2	2	2	2	3	4	4	4	4	4

Issuance (in EUR million)	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Total Covered Bonds Issuance										
New Issues of CBs - Pfandbriefe	4,171	4,967	4,559	5,316	9,414	10,834	11,227	12,804	12,568	13,343
New Issues of CBs - Structured	-	-	-	-	3,000	4,000	4,152	6,919	1,015	5,850
Total Issuance	4,171	4,967	4,559	5,316	12,414	14,834	15,379	19,723	13,583	19,193

Public Placement										
Benchmark (1bn and above)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	6,919	906	5,250
Benchmark (500Mio - 999Mio)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	2,394	2,171	4,562
Others (below 500Mio)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	10,410	10,397	8,782
Private Placement	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	-	109	600
Total	4,171	4,967	4,559	5,316	12,414	14,834	15,379	19,723	13,583	19,193

Denominated in EURO	-	-	-	-	3,000	4,000	3,250	2,750	-	5,850
Denominated in domestic currency	4,171	4,967	4,559	5,316	9,414	10,834	11,227	12,804	12,568	13,343
Denominated in other currencies	-	-	-	-	-	-	902	4,169	1,015	-
Total	4,171	4,967	4,559	5,316	12,414	14,834	15,379	19,723	13,583	19,193

Issuance fixed coupon	4,171	4,967	4,559	5,316	12,414	14,834	15,250	19,723	13,474	19,193
Issuance floating coupon	-	-	-	-	-	-	-	-	109	-
Issuance other	-	-	-	-	-	-	129	-	-	-
Total	4,171	4,967	4,559	5,316	12,414	14,834	15,379	19,723	13,583	19,193

Number of New Issuers	-	-	-	-	1	1	-	-	-	-

Note: from 2008 only Limmat bonds are considered as "Private Placements"

5.2.31 UNITED KINGDOM

Outstanding (in EUR million)	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Total Covered Bonds Outstanding										
Regulated - Mortgages	-	-	-	125,764	109,473	125,250	121,623	147,425	114,395	114,654
Regulated - Public Sector	-	-	-	-	-	-	-	-	-	-
Non-regulated - Mortgages	28,384	54,265	84,874	78,092	90,993	77,965	63,429	37,818	18,077	16,143
Non-regulated - Public Sector	-	-	-	-	3,439	3,548	3,656	3,742	5,784	6,152
Total Outstanding	28,384	54,265	84,874	203,856	203,905	206,763	188,707	188,985	138,255	136,949
Public Placement										
Benchmark (1bn and above)	23,250	45,269	72,274	179,076	174,036	171,202	147,473	148,608	112,064	107,687
Benchmark (500Mio - 999Mio)	3,709	6,602	8,909	19,789	24,555	27,738	29,424	27,127	13,341	16,995
Others (below 500Mio)	1,425	2,395	3,691	4,981	5,304	6,643	9,231	9,137	8,637	7,948
Private Placement	-	-	-	10	10	1,180	2,580	4,113	4,213	4,319
Total	28,384	54,265	84,874	203,856	203,905	206,763	188,707	188,985	138,255	136,949
Denominated in EURO	24,676	45,176	69,776	79,338	73,324	81,475	102,084	118,667	84,633	77,968
Denominated in domestic currency	3,648	6,552	7,023	116,049	122,395	115,625	76,905	61,012	44,957	50,972
Denominated in other currencies	60	2,536	8,075	8,469	8,186	9,663	9,718	9,306	8,665	8,009
Total	28,384	54,265	84,874	203,856	203,905	206,763	188,707	188,985	138,255	136,949
Outstanding fixed coupon	25,439	49,956	76,236	78,287	71,342	83,820	111,426	123,888	106,995	101,816
Outstanding floating coupon	2,945	4,309	8,638	125,410	132,563	122,943	77,282	65,097	31,260	35,133
Outstanding other	-	-	-	160	-	-	-	-	-	-
Total	28,384	54,265	84,874	203,856	203,905	206,763	188,707	188,985	138,255	136,949
Number of Programmes	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	18	17
Number of Issuers	5	7	8	19	21	20	16	15	15	14

Issuance (in EUR million)	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Total Covered Bonds Issuance										
Regulated - Mortgages	-	-	-	10,145	8,254	25,000	36,983	37,109	1,480	12,529
Regulated - Public Sector	-	-	-	-	-	-	-	-	-	-
Non-regulated - Mortgages	12,675	25,813	31,673	110,761	22,177	900	-	-	-	-
Non-regulated - Public Sector	-	-	-	-	3,439	-	-	-	-	-
Total Issuance	12,675	25,813	31,673	120,906	33,870	25,900	36,983	37,109	1,480	12,529
Public Placement										
Benchmark (1bn and above)	9,000	22,019	27,165	106,620	27,407	15,412	20,190	22,921	1,000	9,135
Benchmark (500Mio - 999Mio)	2,250	2,829	2,809	13,211	6,001	6,603	9,659	9,432	-	2,892
Others (below 500Mio)	1,425	965	1,698	1,064	462	2,706	5,734	3,222	380	396
Private Placement	-	-	-	10	-	1,180	1,400	1,534	100	106
Total	12,675	25,813	31,673	120,906	33,870	25,900	36,983	37,109	1,480	12,529
Denominated in EURO	10,426	20,500	24,900	10,263	5,535	22,095	27,211	20,024	1,480	6,406
Denominated in domestic currency	2,189	2,829	1,023	110,643	28,335	2,788	8,290	15,041	-	6,123
Denominated in other currencies	60	2,483	5,750	-	-	1,018	1,482	2,044	-	-
Total	12,675	25,813	31,673	120,906	33,870	25,900	36,983	37,109	1,480	12,529
Issuance fixed coupon	9,730	24,472	26,800	2,618	3,750	20,542	35,102	17,991	1,200	6,406
Issuance floating coupon	2,945	1,340	4,873	118,128	30,120	5,359	1,881	19,118	280	6,123
Issuance other	-	-	-	160	-	-	-	-	-	-
Total	12,675	25,813	31,673	120,906	33,870	25,900	36,983	37,109	1,480	12,529
Number of New Issuers	2	2	1	11	3	1	-	-	-	-

Note: There are 12 regulated issuers each with one regulated mortgage programme (some regulated issuers also have unregulated programmes). For more details, please refer to the FCA's website (http://www.fca.org.uk/firms/systems-reporting/register/use/other-registers/rcb-register).

5.2.32 UNITED STATES

Outstanding (in EUR million)	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Total Covered Bonds Outstanding										
Public Sector	-	-	-	-	-	-	-	-	-	-
Mortgage	-	4,000	12,859	12,937	12,888	11,497	9,546	6,000	6,000	4,000
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Outstanding	-	4,000	12,859	12,937	12,888	11,497	9,546	6,000	6,000	4,000
Public Placement										
Benchmark (1bn and above)	-	4,000	12,859	12,937	12,888	11,497	9,546	6,000	6,000	4,000
Benchmark (500Mio - 999Mio)	-	-	-	-	-	-	-	-	-	-
Others (below 500Mio)	-	-	-	-	-	-	-	-	-	-
Private Placement	-	-	-	-	-	-	-	-	-	-
Total	-	4,000	12,859	12,937	12,888	11,497	9,546	6,000	6,000	4,000
Denominated in EURO	-	4,000	11,500	11,500	11,500	10,000	8,000	6,000	6,000	4,000
Denominated in domestic currency	-	-	1,359	1,437	1,388	1,497	1,546	-	-	-
Denominated in other currencies	-	-	-	-	-	-	-	-	-	-
Total	-	4,000	12,859	12,937	12,888	11,497	9,546	6,000	6,000	4,000
Outstanding fixed coupon	-	4,000	12,859	12,937	12,888	11,497	9,546	6,000	6,000	4,000
Outstanding floating coupon	-	-	-	-	-	-	-	-	-	-
Outstanding other	-	-	-	-	-	-	-	-	-	-
Total	-	4,000	12,859	12,937	12,888	11,497	9,546	6,000	6,000	4,000
Number of Programmes	-	1	2	2	2	2	2	2	2	2
Number of Issuers	-	1	2	2	2	2	2	2	2	2

Issuance (in EUR million)	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Total Covered Bonds Issuance										
Public Sector	-	-	-	-	-	-	-	-	-	-
Mortgage	-	4,000	8,859	-	-	-	-	-	-	-
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Issuance	-	4,000	8,859	-	-	-	-	-	-	-
Public Placement										
Benchmark (1bn and above)	-	4,000	8,859	-	-	-	-	-	-	-
Benchmark (500Mio - 999Mio)	-	-	-	-	-	-	-	-	-	-
Others (below 500Mio)	-	-	-	-	-	-	-	-	-	-
Private Placement	-	-	-	-	-	-	-	-	-	-
Total	-	4,000	8,859	-	-	-	-	-	-	-
Denominated in EURO	-	4,000	7,500	-	-	-	-	-	-	-
Denominated in domestic currency	-	-	1,359	-	-	-	-	-	-	-
Denominated in other currencies	-	-	-	-	-	-	-	-	-	-
Total	-	4,000	8,859	-	-	-	-	-	-	-
Issuance fixed coupon	-	4,000	8,859	-	-	-	-	-	-	-
Issuance floating coupon	-	-	-	-	-	-	-	-	-	-
Issuance other	-	-	-	-	-	-	-	-	-	-
Total	-	4,000	8,859	-	-	-	-	-	-	-
Number of New Issuers	-	1	1	-	-	-	-	-	-	-

5.2.33 ANNEX: EUROPEAN CENTRAL BANK EXCHANGE RATES WITH THE EURO, YEAR END

	Australian dollar	Brazilian real	Canadian dollar	Swiss franc	Czech koruna	Danish krone	UK pound sterling
2004	1.7459	3.6201	1.6416	1.5429	30.464	7.4388	0.70505
2005	1.6109	2.7462	1.3725	1.5551	29	7.4605	0.6853
2006	1.6691	2.8141	1.5281	1.6069	27.485	7.456	0.6715
2007	1.6757	2.5914	1.4449	1.6547	26.628	7.4583	0.73335
2008	2.0274	3.2436	1.6998	1.485	26.875	7.4506	0.9525
2009	1.6008	2.5113	1.5128	1.4836	26.473	7.4418	0.8881
2010	1.3136	2.2177	1.3322	1.2504	25.061	7.4535	0.86075
2011	1.2723	2.4159	1.3215	1.2156	25.787	7.4342	0.8353
2012	1.2712	2.7036	1.3137	1.2072	25.151	7.461	0.8161
2013	**1.5423**	**3.2576**	**1.4671**	**1.2276**	**27.427**	**7.4593**	**0.8337**

	Hong Kong dollar	Hungarian forint	Iceland krona	Japanese yen	Korean won (Republic)	Lithuanian litas	Latvian lats
2004	10.5881	245.97	83.6	139.65	1410.05	3.4528	0.6979
2005	9.1474	252.87	74.57	138.9	1184.42	3.4528	0.6962
2006	10.2409	251.77	93.13	156.93	1224.81	3.4528	0.6972
2007	11.48	253.73	91.9	164.93	1377.96	3.4528	0.6964
2008	10.7858	266.7	250*	126.14	1839.13	3.4528	0.7083
2009	11.1709	270.42	179.48*	133.16	1666.97	3.4528	0.7093
2010	10.3856	277.95	153.78*	108.65	1499.06	3.4528	0.7094
2011	10.051	314.58	159*	100.2	1498.69	3.4528	0.6995
2012	10.226	292.3	168.91*	113.61	1406.23	3.4528	0.6977
2013	**10.6933**	**297.04**	**158.29****	**144.72**	**1450.93**	**3.4528**	**0.7025**

* Bloomberg "Compound New York" Rates, ** Bloomberg "Bloomberg Generic Pricing (BGN)" Rates (On December 10, 2008, the European Central Bank has stopped publishing foreign exchange reference rates of the Icelandic Króna)

	Norwegian krone	New Zealand dollar	Polish zloty	Swedish krona	Singapore dollar	Turkish lira	US dollar
2004	8.2365	1.8871	4.0845	9.0206	2.2262	1836200	1.3621
2005	7.985	1.727	3.86	9.3885	1.9628	1.5924	1.1797
2006	8.238	1.8725	3.831	9.0404	2.0202	1.864	1.317
2007	7.958	1.9024	3.5935	9.4415	2.1163	1.717	1.4721
2008	9.75	2.4191	4.1535	10.87	2.004	2.1488	1.3917
2009	8.3	1.9803	4.1045	10.252	2.0194	2.1547	1.4406
2010	7.8	1.72	3.975	8.9655	1.7136	2.0694	1.3362
2011	7.754	1.6737	4.458	8.912	1.6819	2.4432	1.2939
2012	7.3483	1.6045	4.074	8.582	1.6111	2.3551	1.3194
2013	**8.363**	**1.6762**	**4.1543**	**8.8591**	**1.7414**	**2.9605**	**1.3791**

Source: ECB, Statistics Data Warehouse.
Note: The Euro is the denominator.
Note: The exchange rate protocol used for ECBC covered bond statistics is to take the ECB bilateral exchange rate on the last business day of the year.

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