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Executive summary

Covered bonds continue to play a central role in the funding strategies of European Union's (EU's) credit institutions and are in addition becoming increasingly used also outside the EU. They remain a key long-term funding tool of the EU economy and have confirmed their position as a reasonably resilient source of financing in times of distress, most recently during the financial crisis. Until now, the framework has relied on principle-based EU regulation focusing on core elements of the covered bond regulatory treatment, whereas the actual implementation has been left at national level, resulting in different national approaches as regards key technical issues. With the objective of strengthening the EU covered bond regulation, in 2014, the EBA identified a series of best practice recommendations to cover areas not reflected in common EU legislation.

The present EBA report on covered bonds builds on the previous work and provides additional recommendations on how to further harmonise the national frameworks. This is done in the context of overall assessment of the functioning of national covered bond frameworks under the EBA's best practices from 2014, as requested under the recommendation of the European Systemic Risk Board (ESRB) on funding of credit institutions.

In response to the ESRB recommendation, the EBA has undertaken a comprehensive analysis of regulatory developments in covered bond frameworks in individual Member States, with a particular focus on the level of alignment with the EBA's best practices. The results of this analysis are presented in Chapter 1 of this report. This is complemented by an assessment of the latest market trends, as well as regulatory developments that have taken place at the European level, which is presented in Chapter 2 of the report. Building on the results of this study, the report presents, in Chapter 3, a comprehensive proposal for a 'three-step approach' to the harmonisation of covered bond frameworks in the EU.

Developments in national covered bond frameworks and the implementation of the EBA's best practices

The analysis of national regulatory covered bond frameworks in the EU, based on self-assessments by competent authorities and covering 22 Member States (including the ones with the most active covered bond markets), has revealed that the EBA's best practices have been implemented divergently across the EU. While the level of alignment is relatively high for the majority of best practices (with more than half of the jurisdictions assessed as fully aligned with these best practices), in the case of five best practices, the level of adherence is low (with less than half of the jurisdictions fully adhered to these best practices).

Furthermore, the analysis has confirmed an existing diversity of legal, regulatory and supervisory covered bond frameworks across the EU. It has also been observed that only 10 jurisdictions have undertaken action since the publication of the 2014 EBA report to amend their covered bond frameworks, while - pending the results of the European Commission's (the Commission's)



ongoing review of the covered bond framework – majority of the responding jurisdictions (12) have either not implemented any changes to their frameworks or the action has been put on hold.

The EBA's review indicates a strong adherence across European covered bonds systems to the core structural pillars of covered bonds related to dual recourse, segregation of cover assets, the guarantee of the coverage principle, as well as structural features of the bankruptcy remoteness of covered bonds.

On the other hand, the analysis demonstrates the existence of significant differences between the individual Member States, particularly in special public supervision frameworks, as well as in terms of implementation of a liquidity buffer to address liquidity risks associated with the covered bond programme, composition of the cover pool, stress testing for the calculation of the coverage requirement, and transparency vis-à-vis covered bond investors.

In particular, the analysis of frameworks for special public supervision confirms differences across the EU in the content and level of detail regarding the rules on special public supervision, scope of duties and the powers of supervisory authorities regarding ongoing supervision of covered bond issuers and programmes, as well as the rules on approval and licensing of covered bond programmes. Furthermore, the EBA notes that the divergences extend beyond the regulatory frameworks and are also observed in actual supervisory practices of individual competent authorities in the execution of special public supervision.

Latest market trends and regulatory developments in relation to covered bonds

Overall, the observed market and regulatory developments confirm the traditional positive approach of both regulators and market participants towards covered bonds. The existing EU banking prudential regulation—particularly in the area of liquidity and resolution—remains covered bond-friendly. Furthermore, regulatory and market developments seem to be particularly intertwined in the case of covered bonds, with the dynamics of covered bond markets especially affected by continued extraordinary monetary policy measures in the euro area. The analysis in the report focuses on the following key trends observed since the publication of the 2014 EBA report:

- Dynamics in issuance and outstanding volume of covered bonds, showing increasing issuance
 of covered bonds both in the EU and worldwide and the expansion of the covered bond
 market outside the EU, including first issuances by Asian countries in 2015 and confirming the
 trend of globalisation of the covered bond market;
- Changes in the composition of the covered bond investor base, with central banks substantially expanding their share as a consequence of the Eurosystem's covered bond purchase programme 3 (CBPP3), and banks maintaining their position as the largest covered bond investors (reflecting favourable regulatory treatment in the EU);



- Continuation of a trend observed in the last decade of an increasing use of mortgages as cover
 pool collateral, conversely coinciding with the declining volume of public sector loans and
 other asset classes in the cover pools;
- Special treatment of covered bonds: (i) in the Eurosystem's CBPP3, which represents the most important factor of the covered bond primary supply and of the increased share of central banks' investments in covered bonds; (ii) in the EU liquidity coverage ratio (LCR) framework, which allows the inclusion of covered bonds in the liquidity buffer and is a crucial driver for banks' investments in covered bonds; (iii) in the EU banking recovery and resolution framework, which exempts covered bonds from the scope of the bail-in instrument;
- Developments in relation to rating agencies, mainly (i) changes in their rating methodologies
 due to exemption of covered bonds from the bail-in tool and improvement in sovereign
 ratings and related country ceilings of covered bond ratings in peripheral Europe (which is
 reflected in upgrades of covered bond ratings and, in turn, in the extension of the eligibility of
 covered bonds under the LCR); and (ii) new rating agencies entering the market for ratings of
 covered bonds;
- Innovation and changes in covered bond structures, which have led to a shift from traditional, 'hard bullet' covered bond structures (whose maturity cannot be extended) towards an increased use of 'soft bullet' and 'conditional pass-through' (CPT) formats for covered bonds, allowing an extension of maturity to 1 year usually for soft bullet structures or to more than 30 years for CPT structures;
- Increase in transparency for the covered bond market through several market initiatives, particularly the development of the Harmonised Transparency Template (HTT) by the European Covered Bond Council (ECBC).

The report also provides an overview of recently finalised, ongoing and upcoming regulatory initiatives that are expected to have implications for covered bonds in the near future. They include the regulatory technical standards (RTS) on risk mitigation techniques for over-the-counter (OTC) derivative contracts not deared by a central counterparty (CCP), the implementing technical standards (ITS) on mapping of external credit assessment institutions' (ECAIs') credit assessments, and the Commission's public consultation on covered bonds. Lastly, a reference is made to the EBA recommendation on the need for a holistic review of the regulatory framework, which also has direct relevance for covered bonds.

The EBA recommendations on a three-step approach to the harmonisation of covered bond frameworks in the EU

Building on the condusions of the EBA's analysis (which confirmed existing diversity in national covered bond frameworks, significant market and regulatory developments with direct impact on covered bonds, and the overall importance of covered bonds for the funding of the EU economy), the EBA has developed a three-step approach to the harmonisation of covered bond frameworks in the EU and presents a fully fledged proposal of this framework in this report.



The framework builds on the strengths of the existing national frameworks, while, at the same time, allowing better protection for the covered bond product by ensuring more consistency in terms of definition and regulatory treatment of covered bonds in the EU. This framework aims to ensure that only those financial instruments that comply with the harmonised structural, credit risk and prudential standards can be branded 'covered bonds' and have access to special regulatory treatment and preferential risk weights, as offered in the current EU financial regulation.

Importantly, the proposal seeks to provide a balanced and pragmatic solution to harmonisation that meets harmonised prudential objectives while, at the same time, building on existing well-functioning national covered bond markets, keeping flexibility and specificaties of national covered bond frameworks and leaving room for varying national implementations (where appropriate).

Step I – EU Covered Bonds Directive

The EBA recommends developing a new covered bond framework applicable across different financial sectors and based on the minimum harmonisation principle, the objective of which should be to define the 'covered bond' as an instrument recognised by EU financial regulation and to harmonise minimum quality standards of covered bonds across the EU.

The covered bond framework should replace the existing principle-based provisions on covered bonds in the UCITS Directive with a detailed set of requirements applicable to all covered bonds across the EU and covering a wide range of areas necessary for underpinning the quality of the product, including requirements for: (i) the dual recourse of a covered bond, segregation of cover assets and bankruptcy remoteness of a covered bond; (ii) the coverage principle, liquidity risk mitigation and cover pool derivatives; (iii) a system of special public supervision and administration, as well as (iv) transparency and disclosure.

The covered bond framework should also provide a single and consistent point of reference for prudential regulation purposes: all EU regulations that set out specific treatments for covered bonds, such as in relation to liquidity and bail-in, should make reference to the covered bond instrument as defined in the covered bond framework.

Furthermore, the covered bond framework should specify additional conditions for the soft bullet and conditional pass through structures, that would need to met in order to allow such covered bond structures qualify as covered bonds.

Step II – Amendments to the CRR

The EBA recommends enhancing the conditions for preferential risk weight treatment of banks' investments in covered bonds, currently specified in Article 129 of the CRR. All covered bonds across the EU that seek preferential risk weight treatment would thus need to comply with the requirements specified in the covered bond framework, as well as with the strengthened



conditions in the CRR. Apart from these changes, the EBA does not suggest amendments to other covered-bond-related provisions of the CRR.

Besides the existing conditions on the eligibility of cover assets (which should be reassessed) and the loan-to-value (LTV) limits for mortgage cover pools (which should be amended to specify the type of the LTV limits), additional conditions should be introduced in the CRR that establish limits on substitution assets and requirement on overcollateralisation. Existing disclosure requirements for the covered bond issuer should become a standard requirement for all covered bonds (i.e. should be treated in the covered bond framework in Step I).

With regard to cover assets, in line with the condusions from the 2014 EBA report, the EBA recommends that the scope of the cover assets should not be widened. Furthermore, the EBA considers that loans to small- and medium-sized enterprises (SMEs), infrastructure loans and loans to additional non-public debtors should not be considered as eligible cover assets for preferential treatment, and further impact analysis should be conducted on the eligibility of ship loans as eligible cover assets.

Step III – Voluntary convergence

The EBA recommends that some specific areas of the covered bond business are subject to voluntary convergence, taking into account that their harmonisation through a legally binding instrument is less relevant from the perspective of the overall robustness of covered bond frameworks and/or could potentially have an unintended disruptive effect on the good functioning of national markets.

Irrespective of the type of instrument that would be chosen to achieve such voluntary convergence, the EBA recommends that the areas covered relate to a composition of the cover pools, requirements for cover pools with underlying assets/obligors located in jurisdictions outside the European Economic Area (EEA), LTV measurement and frequency of revaluation, and stress testing by the covered bond issuer. On a longer-term, also greater harmonisation could be pursued in these areas, but at the current stage, these issues are assessed to be secondary for the soundness of the covered bond product.



EBA recommendations

Recommendation 1 – Three-step approach to the harmonisation of covered bond frameworks in the EU

The EBA recommends a three-step approach to the harmonisation of covered bond frameworks in the EU—i.e. it recommends strengthening the currently applicable regulatory rules in relation to covered bonds and harmonising the practices observed in various areas of the covered bond business within one of the following three steps:

- Within Step I—i.e. in the newly developed covered bond framework, which would aim to provide a definition of the covered bond product as an instrument recognised by the EU financial regulation (implementation via directive is recommended). All covered bonds seeking regulatory recognition would need to comply with the requirements specified in Step I;
- Within Step II—i.e. through targeted amendments to the CRR provisions on covered bonds, which would aim to enhance conditions for the access to preferential risk weight treatment of covered bonds. All covered bonds seeking preferential risk weight treatment would need to comply with the requirements specified in the Step I as well as in Step II;
- Within Step III—i.e. through non-binding instruments with a view of stimulating voluntary convergence between national frameworks in specific areas (taking into account that noncompliance with the recommendations in this area would not have impact on the eligibility of the covered bonds for preferential regulatory and risk weight treatment).

Recommendation 2 – Development of a covered bond directive

The EBA recommends the development of a new covered bond directive, the objective of which would be to define the covered bond as an instrument recognised by EU financial regulation. The covered bond framework should specify the core elements of the covered bond mechanism and a set of harmonised minimum quality standards of regulated covered bonds. It should replicate and further specify the aspects currently regulated by the UCITS Directive (which in substance defines the covered bond product), as well as include a number of additional elements (predominantly structural in nature and not covered by the UCITS Directive) that are considered relevant for underpinning the quality standards of the product.

The covered bond framework would provide a single, consistent and sufficiently detailed point of reference for prudential regulation purposes; all other EU regulations that set out specific



treatments for covered bonds¹ should make reference to the covered bond instrument as defined in the covered bond framework.

The covered bond framework should be applicable across different financial sectors and be based on the minimum harmonisation principle. It should replace all the existing provisions related to covered bonds in the UCITS Directive (in Article 52(4)).

The areas covered by the covered bond framework should include the following structural quality requirements:

- Requirements on the dual recourse of a covered bond, segregation of cover assets and bankruptcy remoteness of the covered bond;
- Requirements on the coverage principle, liquidity risk mitigation and cover pool derivatives;
- Requirements on a system of special public supervision and administration related to covered bonds, including requirements for a cover pool monitor, supervision of the issuer on an ongoing basis, supervision in the event of the issuer's insolvency/resolution, and administration of the covered bond programme post the issuer's insolvency/resolution;
- Transparency requirements—i.e. scope, format and frequency of disclosure.

With regard to covered bonds involving soft bullet and conditional pass through (CPT) amortisation structures, the EBA recommends these qualify as covered bonds, as long as they comply with some additional requirements. Under these requirements, the maturity extension may not be effected at the discretion of the issuer, and may only be effected subject to specific triggers/conditions.

Apart from the requirement on dual recourse, coverage principle and disdosure requirements (which represent extensions of existing regulatory requirements in the UCITS Directive or the CRR), all the above areas represent new rules currently not covered by EU legislation.

Recommendation 3 – Introduction of amendments to CRR

The EBA recommends amending and enhancing the conditions for the access of covered bonds to preferential risk weight treatment as specified in Article 129 of the CRR, as follows:

- Additional (new) conditions for preferential risk weight treatment should be introduced, setting out (i) limits on substitution assets, and (ii) minimum effective overcollateralisation at the covered bond level;
- Existing provisions on LTV limits for cover assets collateralised by physical property (i.e. for mortgage cover pools) should be amended so as to specify the type of the limits (while the

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¹ Such as inclusion of covered bonds in the LCR liquidity requirements, exclusion of covered bonds from the bail-in under the BRRD, exemption of the cover pool derivatives from the margin requirements under RTS on OTC derivatives not cleared by a CCP



current levels of the LTV limits should be maintained);

- Existing provisions on disclosure requirements for the covered bond issuer should be enhanced and shifted to the covered bond framework (i.e. in Step I) and should thus become a standard requirement for all regulated covered bonds rather than a specific condition for those covered bonds seeking preferential risk weights;
- Existing provisions on the eligibility of cover assets should be reassessed. In line with the
 conclusions from the 2014 EBA report, the EBA recommends that the scope of cover assets
 should not be widened. Furthermore, the EBA considers that loans to SMEs, infrastructure
 loans and loans to additional non-public debtors should not be considered eligible cover
 assets for preferential treatment, and further impact analysis should be conducted on the
 eligibility of ship loans as eligible cover assets.

All in all, the EBA recommends that the criteria for preferential risk weight treatment should include the following four elements: (i) requirements on eligible cover assets; (ii) limits on substitution assets; (iii) LTV limits for mortgage cover pools; and (iv) minimum effective overcollateralisation at the covered bond level. Apart from those mentioned above, the EBA does not suggest amendments to other covered-bond-related provisions of the CRR.

Recommendation 4 – Voluntary convergence of national covered bond frameworks

The EBA recommends that some specific areas are subject to voluntary convergence, taking into account that their harmonisation through a legally binding instrument is considered less material from the perspective of the overall robustness of the covered bond frameworks and/or could potentially have an unintended disruptive effect on the good functioning of national markets.

These areas relate to: (i) composition of cover pools; (ii) requirements on cover pools with underlying assets/obligors located in jurisdictions outside the EEA; (iii) LTV measurement and frequency of revaluation; and (iv) stress testing by the covered bond issuer.



The EBA mandate and previous work

On 1 July 2014, the EBA issued a 'Report on EU covered bond frameworks and capital treatment' (2014 EBA report), ² which—in line with the mandate given to the EBA in the ESRB recommendation on the funding of credit institutions from December 2012 (ESRB recommendation)³—identified best practices with a view to ensuring robust and consistent frameworks for covered bonds across the EU. The report also contained the EBA's opinion on the adequacy of the current prudential treatment of covered bonds, following a call for advice from the Commission from December 2013 based on the Article 503 of the CRR.

ESRB recommendation E related to covered bonds:

'National supervisory authorities are recommended to identify best practices regarding covered bonds and encourage harmonisation of their national frameworks. [...] The EBA is recommended to coordinate actions taken by national supervisory authorities, particularly in relation to the quality and segregation of cover pools, insolvency remoteness of covered bonds, the asset and liability risks affecting cover pools and disclosure of the composition of cover pools.

...

'By 30 June 2014,⁴ the EBA is requested to deliver to the ESRB an interim report setting out the principles of best practice in relation to covered bonds which it has identified together with national supervisory authorities.'

The comprehensive assessment in the 2014 EBA report on national legal and regulatory covered bond frameworks, supervisory practices and standards of transparency towards investors found general heterogeneity among applicable rules across jurisdictions. With the aim of ensuring a common minimum level of quality across the covered bond products issued in the EU and of strengthening the prudential justification for preferential regulatory treatment of the product across the Single Market, the EBA identified a list of crucial areas for covered bond regulation and, for each of those areas, best practice recommendations.

The areas covered by best practices include the following: dual recourse mechanism (best practice 1); segregation of cover assets and bankruptcy remoteness of covered bonds (best practices 2A, 2B and 2C); characteristics of the cover pool (best practices 3A and 3B); valuation of cover assets, LTV limits and other requirements on mortgage cover assets (best practices 4A and 4B); coverage principles and legal/regulatory overcollateralisation (best practice 5); assets and liability risk management: use of derivatives, liquidity buffer and stress testing (best practices 6A,

²EBA report on EU covered bond frameworks and capital treatment, July 2014: https://www.eba.europa.eu/-/eba-supports-capital-treatment-of-covered-bonds-but-calls-for-additional-eligibility-criteria.

³ ESRB recommendation on funding of credit institutions (ESRB/2012/2, Recommendation E), December 2012 (ESRB/2012/2):

 $[\]frac{\text{https://www.esrb.europa.eu/pub/pdf/recommendations/2012/ESRB_2012_2.en.pdf?8de3922e86b0f4863bc6e748f1f1}{\text{a 4c0.}}$

⁴ Following the extension of the deadlines for the fulfilment of the recommendation: https://www.esrb.europa.eu/pub/pdf/recommendations/2014/140916_ESRB_Decision_annex.en.pdf?31fa4d50a75b9fc04dcf937a2d60d8ac.



6B and 6C); role of the competent authority and monitoring of the cover pool (best practices 7A, 7B and 7C); and disclosure to investors (best practices 8A and 8B).

Furthermore, while expressing support for the current approach laid down in the CRR, the EBA recommended additional criteria for covered bonds to qualify for preferential risk weight treatment. In particular, the EBA recommended that the additional qualifying conditions should cover minimum regulatory overcollateralisation, requirements for liquidity risk mitigation, a more detailed role for competent authorities and special public supervision, and more detailed specification of disclosure requirements (recommendations EUCOM 1-A to 1-D).

Finally, the 2014 EBA report advised on preferential treatment of some specific cover assets. It concluded that residential guaranteed loans should be maintained within the scope of preferential risk weight treatment. However, it recommends not including aircraft liens in the scope and not renewing the derogation on the use of residential mortgage-backed securities (RMBSs) and commercial mortgage-backed securities (CMBSs) as cover assets beyond December 2017.

As a follow-up to the identification of best practices, the ESRB recommendation stipulates the following:

ESRB recommendation E related to covered bonds:

'The EBA is recommended to consider whether it is appropriate to issue guidelines or recommendations endorsing best practices, after monitoring the functioning of the market for covered bonds by reference to these best practices for a period of 2 years. If the EBA identifies the need for a legislative proposal in this regard, it should report to the European Commission and inform the ESRB.

. . .

'By 30 June 2016, the EBA is requested to deliver a final report to the ESRB and to the Council containing an assessment of the functioning of the framework for covered bonds under the best practice principles and its view on recommended further action if deemed desirable.'

In response to this recommendation, the EBA has undertaken a comprehensive analysis in 2016 focused on an assessment of main market trends and latest regulatory developments at EU level since the publication of the 2014 EBA report, as well as an assessment of legal and regulatory developments in national covered bond frameworks (including the level of alignment of the national frameworks with the EBA's best practices).

This report presents the results of the analysis, as well as the EBA's view on recommended further action as a follow-up to that analysis.



Chapter 1: Analysis of developments in national covered bond frameworks

1.1 Methodology, coverage and principles of the analysis

For the purposes of the assessment of the developments in national covered bond frameworks, the EBA has substantially relied on self-assessments made by national competent authorities, which were provided to the EBA via responses to a dedicated questionnaire distributed by the EBA in first half of 2016.

The self-assessments by the competent authorities have been reviewed by the EBA and moderated for consistency purposes across jurisdictions in a limited number of cases, when considered necessary. The analysis has been supported, to a limited extent, by the data published in the 2014 EBA report and by the data available on the ECBC's website.

The questionnaire focused on the implementation of each best practice identified in the 2014 EBA report by the Member States in their national covered bond frameworks, and on other relevant developments in these frameworks that have taken place since the publication of the 2014 EBA report.

The information has been collected from, and validated by, the competent authorities of the following EU Member States: Austria, Belgium, Cyprus, the Czech Republic, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Poland, Portugal, Romania, Slovakia, Slovenia, Spain, Sweden and the United Kingdom. Information collected from Norway is also included in this report. The assessment thus covers 22 jurisdictions in total (referred to hereafter as the responding jurisdictions), including jurisdictions with the most active covered bond markets.

Bulgaria, Hungary and **Malta** have not responded to the questionnaire. **Estonia** and **Croatia** informed the EBA that they do not currently have a legal/regulatory covered bond framework in place. **Lithuania** noted that existing covered bond regulation is not applied in practice due to absence of covered bond market activities, hence it has not been changed since 2014. **Latvia** informed that there have been no covered bond issuances since the last mortgage covered bond matured in 2012 and the covered bond legislation has not been amended since 2006. As a consequence, these seven jurisdictions systematically do not appear in this report.

In the analysis, the EBA took account solely of the national legal and regulatory frameworks in place and did not give consideration to the supervisory frameworks and the contractual specificities that may exist under individual covered bond programmes within a given framework.



It should be highlighted that the assessment has not been subject to a peer review by the competent authorities and—as mentioned above—builds substantially on the self-assessments made by the national authorities. As such, it may contain elements of subjective considerations.

The national framework is only considered fully aligned with a best practice under consideration in situations where a mechanism exists in national legal and regulatory framework that is specifically designated to address the regulatory concern behind that best practice. When the framework addresses some but not all of the aspects of that best practice, the framework is assessed as partially aligned. One should keep in mind the broadness of the category of the partial assessment, as it covers a wide range of situations ranging from overall compliance with the majority of the individual aspects of the best practice to compliance with a minor subset of it. Those frameworks that do not address any of the issues covered by the best practice or those frameworks that are silent on the issues are considered as non-aligned with the best practice. Therefore, the criteria used for dassifying a certain jurisdiction as fully, partially or non-aligned disregards those situations where, in practice, issuers in a certain jurisdiction are effectively compliant with a certain best practice although their national legal framework does not specifically address such a matter or addresses the same matter differently from the EBA recommendations.

Furthermore, one should take into account that different best practices may have different levels of importance and weight from the perspective of the overall strength and quality of the covered bond business. A comparison of the individual frameworks based solely on quantitative factors, without considering wider qualitative considerations, should therefore be avoided.

Lastly, it is to be noted that, in a number of jurisdictions, there coexist more than one type of regulated covered bonds; the assessment in this report generally covers all of these. This is with the exception of Spain, where assessment is focused on the cédula hipotecarias (CH), which is the most common type of covered bonds representing the majority of the outstanding bonds in this jurisdiction.

For information on the terminology used throughout the document, see Figure 1.



Figure 1: Terminology used in the report

Terminology used in the report

'Resolution authority' is the resolution authority as defined by the Banking Recovery and Resolution Directive (BRRD)⁵—i.e. the authority empowered to apply the resolution tools and exercise the resolution powers in accordance with the BRRD.

'Competent authority' is the authority vested by the national covered bond regime with the function of exercising special public supervision for the benefit of the covered bond investors. In this sense, the competent authority is not necessarily the same authority as the one responsible for the general prudential supervision of credit institutions.

'Resolution' means the application of resolution tools in order to achieve one or more of the resolution objectives, as defined by the BRRD.

'Insolvency' means 'normal insolvency proceedings' as defined by the BRRD—i.e. collective insolvency proceedings that entail a partial or total divestment of a debtor and the appointment of a liquidator or an administrator normally applicable to institutions under national law and either specific to those institutions or generally applicable to any natural or legal person.

The term 'bankruptcy' is only used in this document in the context of the bankruptcy remoteness of the covered bond from the covered bond issuer. This term is used in accordance with Article 300 of the CRR relating to own funds requirements for exposures to a CCP, which defines the term 'bankruptcy remote' (in relation to client assets) as a condition when effective arrangements exist ensuring remoteness of client assets in the event of insolvency of the CCP or clearing member or in the event of client default. The term 'bankruptcy' is not defined in EU legislation. The general understanding is that while insolvency is the financial state of being unable to pay off the debts on time, bankruptcy is a legal process available in the legal systems of some but not all Member States and which serves the purpose of resolving the issue of insolvency. Insolvency is thus essentially understood as the state of being that prompts one to file for bankruptcy—i.e. bankruptcy is one of a number of solutions offered under national insolvency laws to address the state of insolvency.

'Covered bond programme' refers to the perimeter of claims and obligations as well as activities related to a specific covered bond product of the issuer, and to which protective measures of the respective covered bond regime would apply in the issuer's insolvency. Different issuances (different International Securities Identification Numbers (ISINs)) of the same covered bond programme do not constitute separate covered bond programmes. For the purposes of this report, the term 'covered bond programme' is to be read as also referring to covered bond activities executed by specialised covered bond issuers in some jurisdictions, where a licencing procedure refers to covered bond activities rather than to covered bond programmes.

'Universal credit institution' refers to a credit institution that is allowed, by law, to diversify its business and funding sources and is not required to focus on a specific business line (e.g. mortgage lending). The liabilities side of their balance sheet is not only composed of equity and covered bonds, but also of other types of liabilities, including deposits, unsecured liabilities and subordinated liabilities.

'Specialised credit institution' refers to a special type of credit institution that is required by law to specialise in a given lending activity (e.g. mortgage lending) and that tends to finance itself almost exclusively, or exclusively, by issuing covered bonds. Thus, as such, it has its activities restricted by law.

'Issuer' refers to a credit institution with its registered office in a Member State, being a universal or specialised credit institution, that issues covered bonds.

⁵ Directive 2014/59/EU establishes the framework for the recovery and resolution of credit institutions and investment firms: http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014L0059&from=en.



1.2 Overview of amendments in national covered bond frameworks since 2014

The EBA has observed that almost half of the responding jurisdictions (10 out of 22 altogether) have undertaken action since the publication of the 2014 EBA report to amend their covered bond frameworks, some of whom have had the particular aim of adopting the identified best practices. More than half of the responding jurisdictions (12 out of 22) have either not implemented any changes to their frameworks or action is on hold pending the results of the Commission's ongoing review of the EU covered bond framework. More concretely:

- Six jurisdictions have amended their framework (Germany, the Netherlands, Norway, Poland, Romania and Sweden);
- Four jurisdictions are in the process of amending their frameworks or proposing to amend them (the Czech Republic, France, Greece and Slovakia);
- In three jurisdictions, the action (either intended or already started) is on hold pending the Commission's review (Austria, Ireland and Spain);
- In nine jurisdictions, no changes were implemented to their frameworks (Belgium, Cyprus, Denmark, Finland, Italy, Luxembourg, Portugal, Slovenia and the United Kingdom);
- Seven jurisdictions are not covered in the report (Bulgaria, Croatia, Estonia, Hungary, Latvia, Lithuania and Malta).

See Annex 2 for detailed information on national covered bond frameworks and the changes introduced to the frameworks following the 2014 EBA report.

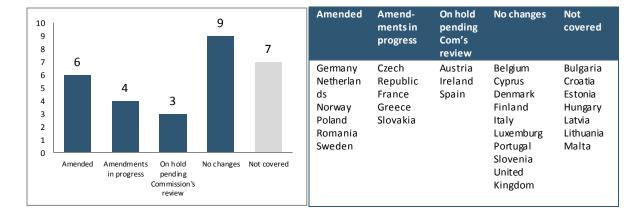


Figure 2: Overview of amendments in national covered bond frameworks since the 2014 EBA report

Amended covered bond frameworks

The following six jurisdictions have amended their national covered bond frameworks since the publication of the 2014 EBA report with the purpose of better aligning the respective frameworks with the EBA's best practices and/or further strengthening the legislative regimes more generally: **Germany, the Netherlands, Norway, Poland, Romania and Sweden.**



Two main amendments have been made to the Pfandbrief Act (the **German** covered bond framework) in the context of the implementation of the BRRD and the transposition of the Single Resolution Mechanism (SRM). The amendments entered into force in December 2014 and November 2015 respectively, and have introduced, inter alia, the following changes: (i) attribution of power to the competent authority (BaFin) to require individually higher coverage than the legal minimum; (ii) introduction of regular reporting on covered bonds, generally on a quarterly basis; (iii) modifications to disclosure requirements, including the introduction of a loan-size-based distribution for public sector covered bonds; and (iv) adjustments to deal with the implications of the involuntary transfers of cover assets and liabilities (e.g. in the context of the implementation of the BRRD).

At the time of publication of the 2014 EBA report, the covered bond law in the **Netherlands** was in the process of being revised and the EBA report had taken into account the draft of the reform available at the time. The final revised covered bond law was subsequently incorporated into the jurisdiction's legislative framework, which entered into force in January 2015 and which implemented additional changes with respect to the draft reform considered in 2014. Among other requirements, the 2015 reform introduced (i) a minimum nominal overcollateralisation requirement; (ii) a liquidity buffer; (iii) the requirement of appointing an external auditor (i.e. a cover pool monitor); and (iv) regular reporting requirements. As a consequence of the changes, the following elements of the Dutch covered bond law have been amended, compared to the 2014 EBA report: (i) the legislation now specifically sets out the types of assets allowed as covered assets; (ii) market value is used for cover pool valuation purposes (whereas previously the foreclosure value was used); and (iii) the definition of liquid assets has been made broader.

Within **Poland**'s covered bond framework, a number of legislations have been implemented or amended since the 2014 EBA report. Firstly, amendments to the bankruptcy legislation that were introduced in January 2016: (i) repealed former barriers to smooth and timely servicing of the bondholders in the case of the issuer's insolvency; and (ii) introduced a soft bullet clause according to which the date of the maturity of the bonds is automatically postponed by 12 months at the bankruptcy of the issuer. Secondly, amendments to the covered bond legislation were introduced in July 2015 that incorporated (among others): (i) an overcollateralisation requirement for covered bonds of at least 10% of the nominal value of the issuance; (ii) liquidity buffers; and (iii) increased limits for refinancing future mortgage loans by covered bonds to up to 80% of the mortgage lending value of a property. Additional amendments made within the Polish covered bond framework include: (i) amendments of detailed requirements on carrying out mortgage cover calculation; (ii) amendments of coverage and liquidity tests; (iii) amendments relating to the cover asset register; and (iv) amendments to criteria for determining the mortgage lending value of the property.

In **Norway**, the legislative framework entered into force in January 2016 and introduced the following main changes: (i) the framework treats the covered bond the same as banks in the event of insolvency (as such, they are no longer able to be dedared bankrupt but are placed under public administration if facing solvency or liquidity problems); and (ii) the ministry of



finance is vested with a power to set a legal minimum overcollateralisation level, as well as to specify more detailed regulation in a number of areas.

In Romania, the new covered bond framework currently in place has been developed with the main objective of complying with the EBA's best practices. The main areas addressed by the new framework include: (i) principles for achieving an effective segregation of the cover assets; (ii) eligibility criteria for the cover assets; (iii) conditions for structuring the cover pool; (iv) supervisory reporting and disclosure obligations; and (v) requirements for the management of assets and liabilities risks in the covered bonds (including the calculation of overcollateralisation requirements, the liquidity risk management, conditions for using derivative financial instruments for hedging the interest rate and foreign exchange risk, stress test factors). The changes also relate to (vi) responsibilities and authorisation of the cover pool monitor, (vii) procedure for the approval by the National Bank of Romania (NBR, as competent authority in charge of prudential supervision of credit institutions), and (viii) administration of the covered bonds after the issuer's default and the involvement of the NBR in this process.

In **Sweden,** an amended covered bond legislation entered into force in June 2016 that includes an overcollateralisation requirement of at least 2%.

Amendments in progress

There are four jurisdictions that are in the process of amending their covered bond frameworks. The legislative reforms—in most cases, driven by the objective to incorporate the EBA's best practices—are scheduled for 2016/2017. These jurisdictions include **the Czech Republic, Greece, France** and **Slovakia**.

Amendments on hold pending the Commission's review

On 30 September 2015, as part of its Capital Markets Union agenda launched in February 2015, the Commission published a consultation document 'Covered bonds in the European Union'. The consultation paper, supported by the accompanying impact assessment analysis, shed light on fragmentation and market efficiency issues in relation to the European market for covered bonds, and offered potential ways forward relating to the regulation of covered bonds in the EU.

Given these developments, three jurisdictions (Austria, Ireland and Spain) have informed the EBA that they are intending to take action following the publication of the Commission's conclusions on the review of the regulatory framework for covered bonds, or that they were in the process of implementing amendments to their covered bond frameworks and have decided to suspend the process pending the outcome of the reform.

In **Austria**, it is intended to harmonise the three existing legislative acts and to strengthen the legal requirements, especially for transparency and risk management. A concrete timeline has not been fixed yet.



Following the publication of the 2014 EBA report, a working group was formed in **Spain** at the regulatory level and was tasked with formulating a reform of the existing framework. Following a comprehensive analysis, the main areas identified for improvement were as follows: (i) possible reduction of the levels of asset encumbrance of issuing institutions, especially regarding CH; (ii) clarification of the rights of the covered bond investors in case of insolvency of the issuing institution by segregating the cover pool; (iii) indexation of the value of the cover pool assets and, when needed, of their collateral; (iv) redefinition of the eligible assets for each type of covered bonds; (v) additional liquidity management measures; (vi) publication of more complete, transparent and homogeneous information by issuing institutions; and (vii) the introduction of the asset pool monitor to supervise the issuer in terms of fulfilling their obligations. The work has been put on hold pending the conclusions of the Commission's initiative.

After the publication of the 2014 EBA report, the authorities of **Ireland** afforded consideration to align the existing covered bond legislation with the EBA's best practices, notably in relation to stress testing, liquidity buffers and disclosure, as well as the interaction between the covered bond regime and the BRRD. The reform has been put on hold to await the conclusion of the Commission's review.

Covered bond frameworks with no amendments

There are nine jurisdictions where no changes to national frameworks have been introduced: Belgium, Cyprus, Denmark, Finland, Italy, Luxembourg, Portugal, Slovenia and the United Kingdom.

It is acknowledged that where no changes were introduced to the national covered bond frameworks this does not imply objections to the best practices identified on the 2014 EBA report.



1.3 Summary of the evaluation of national frameworks' alignment with the EBA's best practices

The EBA's analysis indicates a divergence in the level of alignment with the EBA's best practices across individual jurisdictions, with 12 best practices where more than half of the responding jurisdictions are assessed as fully aligned and 5 best practices where adherence is low (i.e. less than half of the jurisdictions are fully adhered to). The analysis also demonstrates an existing diversity of national covered bond frameworks from legal, regulatory and supervisory perspectives.

In particular, the best practices that relate to the core structural features of covered bonds have been very well adhered to, such as best practice 1 on dual recourse (where every jurisdiction is fully aligned) and best practice 2 – A on segregation of cover assets (where all but one jurisdictions are fully aligned). Best practice 2 – B on bankruptcy remoteness—another essential feature directly related to the dual recourse—seems to be moderately adhered to; however, this is principally due to lack of requirements in the national regulatory frameworks regarding issuers' operational procedures to be in place to ensure a smooth switch to administration function upon insolvency/resolution. The structural features of bankruptcy remoteness seem to be fully complied with.

Other best practices with a high level of adherence include best practice 5 on the coverage principle (another fundamental element of covered bonds that ensures full coverage of liabilities of covered bond programmes throughout the validity of the programmes), as well as best practice 4— A on LTV limits (which determines the portion by which loans secured by immovable property contribute to the coverage requirement and which is hence strictly connected to the coverage requirement). Other best practices with a high level of adherence are best practice 6-A on the use of derivatives aiming to prevent the issuer from entering into speculative transactions, and best practice 3-B, aiming to provide criteria for the robustness of host covered bond frameworks in cases where the underlying assets are located in different jurisdictions. In all these areas, at least 70% of the responding jurisdictions are assessed as fully aligned.

Despite a number of individual covered bond frameworks being self-assessed as aligned with best practices on the supervision of covered bonds (i.e. best practice 7 – A on the cover pool monitor; best practice 7 – B on supervision of the issuer; best practice 7 – C on supervision in case of the issuer's insolvency/resolution; best practice 2 – C on the administration of the covered bond programme post the issuer's insolvency/resolution), the EBA's analysis confirms that there are significant differences between the individual frameworks, particularly with regard to the content and level of detail of the rules on special public supervision of covered bonds, scope of duties and powers of supervisory authorities regarding ongoing supervision of covered bond issuers and programmes, and rules on approval/licensing of covered bond programmes and hence the overall strength of the national frameworks for special public supervision. The EBA notes that the divergences extend beyond the legal/regulatory frameworks and are also observed in actual supervisory practices of individual competent authorities in the exercise of special public supervision.



Overall, the EBA's analysis indicates that, while there is a strong adherence across Europe to the core pillars of the covered bond business related to dual recourse and the coverage principle, there are significant variances in the robustness of regulatory frameworks in the area of special public supervision, as well as in the application of such supervision.

Best practice 4 - B on LTV measurement and frequency of revaluation shows a moderate level of alignment—however, more than half of jurisdictions are still fully aligned—this being, in most cases, due to non-compliance with the recommendation on the frequency of revaluation, rather than with recommendations on the independence and transparency of the revaluation process.

For 5 (out of 17) best practices, the alignment with the best practice has been low, with each of them being followed by less than half of the responding jurisdictions. This concerns the following areas: scope and frequency of disdosure of data on cover assets and covered bonds, existence of liquidity buffer to address liquidity risks associated with covered bond programmes, composition of the cover pool and stress testing on the calculation of the coverage requirement.

With regard to the scope of disdosure (best practice 8 – A), the EBA recommended that, in order to enable investors to carry out a comprehensive risk analysis, covered bond frameworks should require covered bond issuers to disdose aggregate data on credit, market and liquidity risk characteristics of cover assets and covered bonds, including information on counterparties involved in the programme and levels of contractual (i.e. effective) and voluntary overcollateralisation. While, in a number of jurisdictions, fully comprehensive disdosure requirements are laid out, the majority of frameworks do not necessarily reflect all the factors identified as best practice, or requirements on disclosure are absent from the framework.

With regard to the frequency of disclosure (best practice 8 - B), the EBA recommended the disclosure of the information mentioned in the previous recommendation, at least on a quarterly basis. The EBA observed that the required frequency for the disclosure is either less frequent than the identified best practice or not specified within the majority of frameworks.

Concerning the liquidity buffer (best practice 6 - B), the EBA recommended that liquidity risks in the covered bond programmes should be mitigated by the introduction of liquidity buffers, by means of liquid assets available at all times to cover the cumulative net outflows of the covered bond programmes over a certain time frame. This buffer should be distinct from the existing prudential regulation on liquidity (the LCR). The EBA's analysis shows that a liquidity buffer is absent in a majority of jurisdictions. Alternative measures are in place in a number of jurisdictions to tackle the liquidity risks; these, however, do not fully replicate the requirement for a separate liquidity buffer to be in place for the exclusive purpose of the covered bond programme, particularly in the case of the issuer's insolvency.

In relation to the composition of the cover pool (best practice 3 - A), the EBA recommended that cover pools should consist of one primary asset dass. With respect to mixed mortgage cover pools (i.e. those composed of residential and commercial mortgages), the EBA recommended that frameworks should ensure consistency and stability in the composition of such mixed cover pools.



This is to ensure that the risk profile is stable throughout the life of a covered bond. The EBA observed that the majority of jurisdictions are not fully aligned with the EBA's best practice, as they either allow mixed pools and/or do not set out rules on maintaining consistency of mortgage cover pools (however, it has to be noted that, in many jurisdictions, the majority of the outstanding covered bonds are—in practice—collateralised by one asset class, although this requirement is not anchored in the regulatory framework).

Lastly, in the best practice on stress testing (best practice 6 - C), the EBA recommended that covered bond frameworks should require covered bond issuers to carry out stress test exercises on the calculation of the coverage requirement. The EBA also set out a number of factors that need to be taken into account in such stress tests. For a majority of jurisdictions, this best practice is not met, as the national frameworks require some but not all factors to be incorporated into stress testing or there remains a lack of requirement to conduct stress tests altogether.



1.4 Detailed analysis of the national frameworks' alignment with the EBA's best practices

Best practice 1: Dual recourse

Best practice 1: Dual recourse

In accordance with Article 52(4) of the UCITS Directive, the (covered) bond must grant the investor: i) a claim on the covered bond issuer limited to the complete fulfilment of the payment obligations attached to the covered bond, and ii) in the case of the issuer's insolvency, a priority claim on the assets included in the cover pool limited to the complete fulfilment of the payment obligations attached to the covered bond. Should the assets included in the cover pool prove insufficient to fully meet the payment obligations towards the covered bond investor, the covered bond investor should be granted a claim on the covered bond issuer's insolvency estate, which ranks pari passu with the claim of the issuer's unsecured creditors.

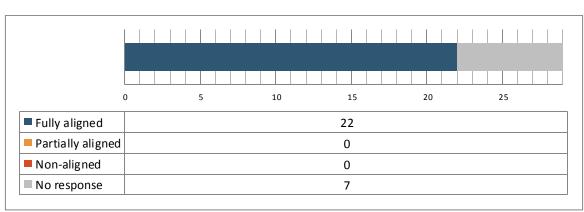


Figure 3: Member States' alignment with best practice 1

Full alignment

The EBA observes that all jurisdictions are aligned with the identified best practice relating to the dual recourse—i.e. recourse to the covered bond issuer and to the assets in the cover pool (for clarification purposes, recourse to the insolvency estate can be understood as an extension of the first limb of the dual recourse principle). Full alignment reflects that the dual recourse is considered a sine qua non of the concept of a covered bond as defined in Article 52(4) of the UCITS Directive.

There exist slight variations in the transposition of the dual recourse principle in national frameworks, which are considered in line with the EBA's best practice:

• In one jurisdiction (Spain), the investor is granted a priority claim on the entire mortgage loan book of the issuer (unless specific exposures are pledged to other parties) and not on a portion of the assets included in the cover pool;



• In two jurisdictions (Denmark and France), the national frameworks applicable to the specialised institutions⁶ establish that the investors are granted a priority claim against the insolvency estate of the specialised issuer (i.e. the claims of the investors rank senior rather than pari passu to the claim of the unsecured creditors). This particularity is directly linked to the covered bond issuer models being specialised credit institutions, and is considered to be compliant with the EBA's best practice. It takes into account the fact that the asset encumbrance is of less relevance for this specific issuance model, as financial payment obligations of the issuer exist exclusively vis-à-vis its parent institution or another member of the same consolidated group (in contrast to the universal credit institution, which has payment obligations towards unsecured creditors).

Partial/no alignment

No jurisdictions have been assessed as being partially aligned or non-aligned with the EBA's best practice.

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⁶ In Denmark, a framework applicable to the universal banks issuing covered bonds grants the investors a claim that ranks pari passu with the claims of the unsecured creditors.



Best practice 2 – A: Segregation of the cover assets

Best practice 2 – A: Segregation of the cover assets

The identification and effective segregation of all the assets over which the investor has a priority claim should be ensured—depending on the issuer model adopted at the national level—either by registration of the cover assets in a cover register or by transfer of cover assets to a special purpose vehicle (SPV) or specialised institution. The covered bond legal/regulatory framework should ensure that the establishment of the cover register and/or the transfer of cover assets to a special entity result in legally binding and enforceable arrangements, including in the event of insolvency or resolution of the issuer.

The segregation arrangement should include all primary assets covering covered bonds, as well as substitution assets and derivatives entered into in order to hedge the risks arising in the covered bond programme.

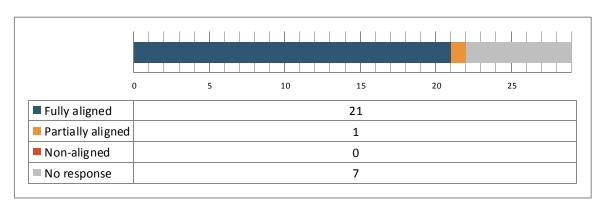


Figure 4: Member States' alignment with best practice 2 - A

Due to intertwined historical and regulatory factors, the covered bond business has developed across Member States in accordance with different models, particularly with regard to the issuance of covered bonds and the segregation of cover assets. While the universal credit institution model is the predominant one, a number of jurisdictions have implemented specific models of covered bond business via specialised institutions or SPVs.

At the time of the 2014 EBA report, the EBA refrained from specifying a preferred model. Although different systems may expose the issuers to different risks (for example, asset encumbrance is of less relevance for the specialised issuers), it is recognised that the typical models observed are well established and perform the task of issuing covered bonds, ensuring dual recourse and segregating cover assets effectively. The choice of the model is henceforth not considered to be decisive for establishing these core principles of the covered bond instrument.



Figure 5: Methods of covered bond issuance and cover assets segregation

Model of cover assets segregation	Model of covered bond issuance	Number of jurisdictions	Jurisdictions
Coverregister	Universal credit institutions	13	Austria, Belgium, Cyprus, the Czech Republic, Denmark,* Germany, Greece, Finland,* Portugal,* Romania, Sweden, Slovenia, Slovakia
Transfer to specialised institutions, cover register	Specialised credit institutions	8	Denmark,** Portugal,** Finland,** France, Ireland, Luxembourg, Norway, Poland
SPVs	Universal/specialised creditinstitutions	3	Italy, the Netherlands, the United Kingdom
No segregation: Recourse to the entire portfolio	Universal credit institutions	1	Spain

^{*} APPLICABLE TO UNIVERSAL COVERED BOND ISSUERS.

Full alignment

The EBA observes that there is a very high level of alignment with the identified best practice, as all but one (21) of the responding jurisdictions are fully aligned. The segregation of cover assets is achieved by applying one of three typical models (it should be noted that, in three jurisdictions—Denmark, Portugal and Finland—there coexist models of both universal and specialised credit institutions). In all 21 jurisdictions, the segregation arrangement covers not only the primary assets, but also substitution assets and derivative contracts (where appropriate).

- Segregation of the cover assets by way of their registration in the cover register is the most common practice, typically observed in universal credit institutions' models, where the cover assets remain on the balance sheet (this system is observed in 13 responding jurisdictions: Austria, Belgium, Cyprus, the Czech Republic, Denmark, Germany, Greece, Finland, Portugal, Romania, Sweden, Slovenia and Slovakia);
- In the case of eight responding jurisdictions (Denmark, Portugal, Finland, France, Ireland, Luxembourg, Norway and Poland) that implement a model of specialised institutions, the cover assets are segregated in the respective specialised institution, which is also typically accompanied by the registration of cover assets in a cover register. Furthermore, in the case of specialised mortgage institutions in Denmark, the segregation of cover assets is achieved by a system of capital centres: in this system, the issuer grants credit loans and issues covered bonds in series called capital centres, each of which disposes of an individual serial reserve fund that remains separate from other funds of the issuer;
- In three jurisdictions (Italy, the Netherlands and the United Kingdom), the segregation is achieved through the *sale/transfer of ownership of cover assets by a universal or specialised credit institution to a SPV*, which is often supported by a guarantee agreement.

^{**} APPLICABLE TO SPECIALISED INSTITUTIONS.



Partial alignment

The framework in Spain for CH provides that the whole mortgage portfolio of the issuer—rather than just a relevant portion of it—represents the cover pool (excluding some specific assets). The framework provides that the claims of the holders of the CH are also secured by substitution assets and the economic flows generated by the financial instruments linked to each bond issue.

The framework, therefore, does not require the segregation of the cover assets per se. However, there are some legal procedures in place in order to reassure the priority claim and the enforceability of mortgage loans, as well as to track eligibility for the purpose of limiting the issuance level. In particular, all mortgages serving as collateral for this type of covered bond must be registered in the land registry. In addition, a special accounting register is kept by the issuers and registers collateral, as well as substitute assets and derivative financial instruments. Based on this, the covered bond framework for this type of covered bond in Spain is considered partially aligned with the best practice under consideration.

No alignment

No jurisdictions have been assessed as non-aligned with the EBA's best practice.



Best practice 2 – B: Bankruptcy remoteness of the covered bond

Best practice 2 – B: Bankruptcy remoteness of the covered bond

The legal/regulatory covered bond framework should not require the payment obligations attached to the covered bond to automatically accelerate upon the issuer's insolvency or resolution, in order to ensure that the options available to the covered bond administration to achieve full and timely repayment of the bonds are not constrained.

The legal/regulatory covered bond framework should ensure that the assets registered in the cover pool and/or transferred to a special entity are treated within insolvency proceedings related to the issuer's insolvency, giving priority to the covered bond investor and any other parties whose claims rank at least pari passu with the claim of the covered bond investor, and do not permit a claim by the issuer's insolvency estate on the cover pool assets other than on a subordinate basis.

The covered bond legal/regulatory framework should ensure that the issuer has a plan in place at all times specifying the operational procedures aimed at ensuring the orderly functioning of the covered bond programme upon insolvency or resolution of the issuer.

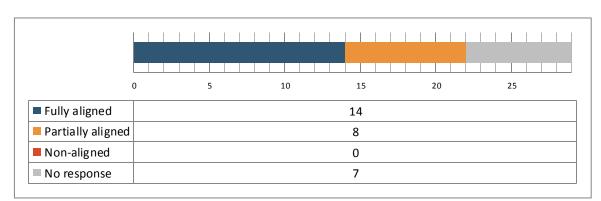


Figure 6: Member States' alignment with best practice 2 – B

Bankruptcy remoteness forms another core concept of the dual recourse structure of covered bonds. According to the EBA's best practice, the covered bond framework should incorporate two aspects of bankruptcy remoteness:

- Structural aspect, according to which the framework should prevent an automatic acceleration of the outstanding covered bonds and ensure priority for investors' claims on assets in the cover pool;
- Operational aspect, according to which the framework should specify the operational procedures that the issuer should have in place, so as to ensure a smooth transition of duties from the issuer to the special administration function in the case of the issuer's insolvency/resolution.



Full alignment

Fourteen jurisdictions are fully aligned with the EBA's best practice on the bankruptcy remoteness of covered bonds and both its structural and operational aspects. These are Austria, Belgium, Denmark, Finland, Greece, Italy, Ireland, Luxembourg, the Netherlands, Poland, Romania, Spain, Sweden and the United Kingdom.

In all these jurisdictions, the covered bond frameworks incorporate necessary *structural features* to ensure the remoteness of the covered bond from the bankruptcy of the issuer and a preferential daim of the covered bond investors on cover assets. These structural features also prevent an automatic acceleration of payment obligations attached to covered bonds upon the issuer's insolvency/resolution. In some jurisdictions, the special administrator is given power to launch an acceleration of the payment obligations upon specific triggers and conditions, including by order of the majority of covered bondholders and approval of the competent authority.

With regard to the *operational procedures*, all 14 jurisdictions have self-assessed their legislative frameworks as incorporating the obligation for the issuer to have such operational procedures in place. The degree of comprehensiveness of such operational procedures required by the regulation varies from one jurisdiction to another, from some basic requirements to fairly comprehensively mapped-out sets of operational processes and internal controls that are updated regularly and discussed with the competent authorities. In some jurisdictions, the operational procedures are specified in the recovery and resolution plans as developed under the BRRD. In the majority of cases, the regulatory frameworks explicitly specify the requirement on operational procedures; in the case of one jurisdiction (the United Kingdom), the assessment of whether issuers have a plan specifying the operational procedures is a requirement for the supervisor and is dealt with through ongoing supervision.

Partial alignment

Eight jurisdictions are assessed as partially aligned with the EBA's best practice: Cyprus, the Czech Republic, Germany, France, Norway, Portugal, Slovakia and Slovenia.

The EBA found that, with respect to the structural aspects of this best practice, these jurisdictions appear fully aligned; however, the reason for partial compliance is the absence of the regulatory requirement—as part of the covered bond framework—for the issuer to have operational procedures in place for an orderly functioning of the covered bond programme upon the issuer's insolvency/resolution. The following has been observed in the partially compliant jurisdictions:

- In some jurisdictions, there is no obligation regarding operational procedures for the issuer enshrined in the regulatory framework, although an operational plan may be required by the competent authorities on an ad hoc/case-by-case basis in the context of supervision;
- In other jurisdictions, the requirement for operational procedures is limited to specific situations—e.g. in the case of resolution proceedings (and not in the case of insolvency proceedings) or in the case of liquidity shortages in the market.



Furthermore, in the framework of the Czech Republic, the covered bond payment obligations accelerate at the final stage of insolvency, once the issuer's bankruptcy has been declared by a court of law.

No alignment

No jurisdictions have been assessed as non-aligned with the EBA's best practice.



Best practice 2 – C: Administration of the covered bond programme post the issuer's insolvency or resolution

Best practice 2 – C: Administration of the covered bond programme post the issuer's insolvency or resolution

The legal/regulatory covered bond framework should provide that, upon the issuer's insolvency or resolution, the covered bond programme is managed in an independent manner and in the preferential interests of the covered bond investor.

The legal/regulatory covered bond framework should offer dear and sufficiently detailed provisions regarding the duties and powers of the administration function so as to ensure that the latter can take all action that may be necessary for the full realisation of the interests of the covered bond investor, while maintaining a high level of legal darity and transparency vis-à-vis the investor in terms of covered bond management in scenarios of potential distress (such as the issuer's insolvency or resolution).

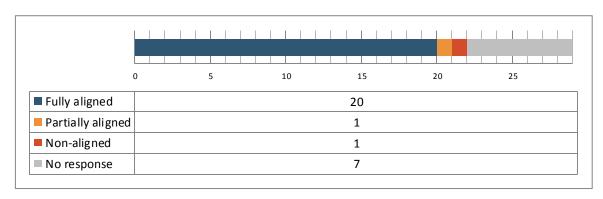


Figure 7: Member States' alignment with best practice 2 - C

Following the issuer's insolvency/resolution, the administrative function takes on a key role in ensuring the fulfilment of all scheduled payment obligations attached to the covered bond programme and satisfying the investors' claims on a priority basis. It is therefore necessary to ensure independence of such special administration functions and establish dear and sufficiently detailed provisions for duties and powers.

Full alignment

There is a high level of alignment with the best practice identified in this area: almost all jurisdictions (20 in total) set out duties and powers of the special administrative function in case of the issuer's insolvency, so as to ensure that the covered bond programme is managed in an independent manner and in the preferential interests of the covered bond investor.

In the majority of these jurisdictions, the administration function is delegated to an entity separate from the insolvency court that deals with the insolvency of the issuer. A national public authority (competent authority, resolution authority or central bank) generally plays a decisive role in the appointment of this independent administrator. In some jurisdictions, the



administration function is executed by the general insolvency court that deals with the insolvency of the issuer. In this case, it is understood that the legislation stipulates specific provisions or separate functions of the general insolvency court with respect to the treatment of covered bondholders.

With regard to the scope and level of detail of the duties and powers of the administration function regarding covered bonds, these vary considerably from one jurisdiction to another: from a basic set of duties and powers to act in the interest of covered bondholders and to complete the fulfilment of liabilities attached to the covered bond, to a large and detailed toolkit of responsibilities and competences enabling the administrator to maximise the returns for covered bondholders' benefit and effectively covering competences of the issuer prior to the insolvency. This includes, for example, the power to sell/transfer part/all of assets and liabilities to another institution, reinvest proceeds in eligible cover pool assets, enter into arrangements to secure liquidity, use derivatives to hedge risks, renegotiate contractual clauses with defaulted obligors in the interest of covered bondholders, issue new covered bonds on behalf of the bank, and various requirements including reporting obligations towards the competent authority.

In some cases, the competences of the special administration function extend beyond the phase of resolution/insolvency of the issuer and cover a wider range of circumstances, such as reorganisation and restructuring measures against the issuer and other situations that may seriously adversely affect the interests of the covered bondholders.

Partial alignment

In the case of Spain, it is the general insolvency practitioner of the issuer that is in charge of the administration of the covered bond programme during insolvency proceedings. The covered bondholders are treated as preferential creditors and the competences of the insolvency practitioner towards preferential creditors include: (i) to cover payments to preferential creditors without disposing of assets assigned a special preference; and (ii) to request of the insolvency court the continuation of the encumbrance of assets assigned a special preference, in case of their sale. This is considered to be partially aligned with the EBA's best practice.

No alignment

In one jurisdiction (the Czech Republic), no specific regulatory framework is in place that sets out the administration function of the covered bond post the issuer's insolvency/resolution.



Best practice 3 – A: Composition of cover pools

Best practice 3 – A: Composition of cover pools

Cover pools—which comprise primary asset classes other than residential or commercial mortgages (not taking into account asset classes included in the pool as substitution assets)—should consist exclusively of one primary asset class.

Cover pools comprising both residential mortgage (or guaranteed) loans and commercial mortgage loans should be structured and managed so as to ensure that the composition by mortgage type (residential vs commercial) which characterises the pool at issuance does not materially change throughout the life of the covered bond for reasons other than the amortisation profile of cover assets. The EBA considers that regulatory limits on the composition of such mortgage pools could represent a best practice to ensure that a certain degree of consistency is maintained in the risk profile of the cover pool throughout the life of the covered bond. The EBA, however, also acknowledges that other tools may equally ensure consistency and stability in the composition of mixed cover pools, including contractual arrangements for the composition of mixed cover pools and supervision of the composition of mixed pools based on supervisory guidelines.

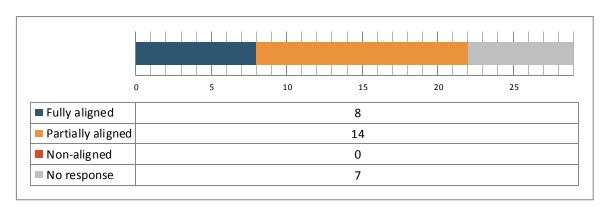


Figure 8: Member States' alignment with best practice 3 – A

The type of primary cover asset has a direct impact on the overall credit risk characteristics of a covered bond. The EBA has, therefore, recommended separating different types of cover assets in different cover pools and only allowing one type of primary cover assets in each cover pool. However, concerning the cover pool composed of mortgages, the EBA acknowledged a market practice of mixing residential and commercial mortgage loans in one cover pool. It has therefore recommended that a proportion of the residential and commercial mortgages in the cover pool should remain stable throughout the life of the programme so as to avoid risks where covered bond investors are considerably exposed to change during the life of the investment.

Based on the EBA's analysis of primary asset classes, all the responding jurisdictions allow mortgages as primary asset class (at least for one of their covered bond programmes), while the majority of them also enable public sector loans. Covered bond frameworks only allowing mortgage cover pools exist in a limited number of jurisdictions (e.g. the Czech Republic and



Romania). A few jurisdictions allow for securitisation notes as primary cover assets (e.g. France⁷, Ireland and Italy). Covered bonds primarily backed by ship loans exist in a few jurisdictions' covered bond frameworks (e.g. Cyprus, Denmark, Germany and Greece).

Full alignment

There is a low level of alignment with this best practice, as only eight jurisdictions are fully aligned (Belgium, Finland, Ireland, the Netherlands, Romania, Slovakia, Slovenia and the United Kingdom).

With regard to the requirement for one primary asset class, in all these jurisdictions, the national regulations allow one primary asset class in the cover pool and explicitly define the allowed primary asset classes. For the purposes of assessment, primary assets are understood as cover assets excluding substitution assets or as otherwise predominant asset classes in the cover pool.

With regard to the requirement for mixed mortgage cover pools, the regulatory frameworks in all these jurisdictions contain provisions that aim to ensure consistency and stability in the composition of such multi-asset cover pools. In the majority of cases, this is achieved through setting out a minimum percentage amount or proportion of one asset class (usually commercial mortgages) that a programme's cover pool must be collateralised with, or, in a minority of cases, through a requirement for the maintenance of a consistent/fixed proportion among the asset classes throughout the life of the programme.

The jurisdictions also generally apply other restrictions on the composition of the cover pool, such as limits on the exposures to financial institutions, quantity and quality of substitution assets, liquidity buffers, rules on the use of derivative instruments, rules on preventing concentration risks, and LTV limits. These rules are disregarded for the purposes of the assessment of alignment with the best practice.

Partial alignment

Fourteen jurisdictions are partially aligned with the EBA's best practice (Austria, Cyprus, the Czech Republic, Denmark, Germany, Greece, France, Italy, Norway, Luxembourg, Poland, Portugal, Spain and Sweden).

The regulatory frameworks in these jurisdictions either allow mixed pools and/or do not set out rules on maintaining consistency between residential and commercial mortgage loans in the mortgages pools. The frameworks, however, provide for other restrictions on the composition of the cover pool that are aimed at ensuring quality of the cover assets and hence safety and stability of the covered bond programmes.

While acknowledging the importance of maintaining homogeneity and high quality of assets in the cover pool, some jurisdictions noted the benefits of mixed pools, as they allow the covered bond issuers to retain the possibility of replacing collateral or adding additional high-quality

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 $^{^{7}}$ Limited to up to 10% of the cover pool from 31 December 2017



collateral to the pool (if needed) in order to fulfil the coverage requirements (also under periods of stress). Some jurisdictions noted that a restriction on mixed pools may potentially lead to reduction in covered bond issuances, especially for small issuers.

It has also been observed that, in a number of these jurisdictions, the majority of outstanding covered bonds are (in practice) collateralised by one primary asset class, and mixed pools are (in practice) very limited or even non-existent.

No alignment

No jurisdictions have been assessed as non-aligned with the EBA's best practice.



Figure 9: Overview of the rules on the composition of cover assets

Jurisdiction	Primary asset classes allowed in the cover pool	More detailed information on cover pools	Substitution assets	Derivatives allowed in the cover pool
Austria	Mortgages, public sector loans, eligible bonds.	Under the Pfandbriefgesetz (PfandBG) and Hypothekenbankgesetz (HypBG) frameworks, the legislation stipulates separation between mortgage and public sector covered bonds. Under the Gesetz betreffend fundierte Bankschuldverschreibungen (FBSchVG) framework, the cover pools can comprise mortgages, public sector loans and eligible bonds in one cover pool. Regulatory limits on the composition of the cover pool are not established; however, in accordance with the law, issuers may establish separate reserve funds for public sector covered bonds and for other covered bank bonds (in practice, under that law, issuers indeed form separate pools with mortgages and public sector assets as well, each backing a separate class of covered bonds).	15% of the amount of issued covered bonds.	Yes
Belgium	Residential mortgages, commercial mortgages, public sector loans.	The cover pool must contain one of the three primary eligible asset classes (residential mortgage, commercial mortgage, public loans) and it must represent at least 85% of the value of the outstanding covered bonds. The remaining cover pool (substitution assets, maximum 15% of the issued bonds) may contain assets of the other two types but also exposures to credit institutions and derivatives.	15% of the amount of issued covered bonds.	Yes
Cyprus	Residential mortgages, commercial mortgages, public loans, ship loans and any other loans determined by the competent authority.	The cover pool can be composed of residential mortgages, commercial mortgages, public loans, ship loans and any other loans determined by the competent authority. Mixed pools are allowed. The framework sets out criteria and conditions for the cover assets.	15% if issued covered bonds for basic collateralisation, 5% for supervisory collateralisation.	Yes
Czech Republic	Residential mortgages, commercial mortgages.	Mortgages (residential and commercial) are the only asset classes allowed in the cover pool. However, no restrictions exist on mixed mortgage pools.	10% of the amount of issued covered bonds.	No
Denmark	For universal banks: Mortgages, ship loans. For specialised mortgage institutions: Mortgages.	The primary asset classes are limited to mortgages or ship loans (for universal banks) and to mortgages (for specialised mortgage institutions). With regard to the universal banks, the cover pool cannot contain both mortgages and ship loans. The balancing and match funding principles are core features of the Danish system, implying a close match between the loan and the bonds funding the loan. Furthermore, the covered bond issuer describes the composition of the cover pool in detail in the prospectus and discloses information hereof. Consistency and stability is, thus, achieved through the match funding principle and transparency.	15% of the amount of issued covered bonds for exposures to credit institutions.	Yes
Finland	Residential mortgages, commercial mortgages, public sector loans.	At least 90% of the cover pool must be formed by residential mortgages, public sector loans or substitution assets, and a maximum of 10% can be assigned to commercial mortgages.	20% of cover assets.	Yes
France	Obligations Foncières (OF): Public sector loans, mortgage loans, guaranteed real estate loans, group-originated senior mortgage-backed securities (MBSs), senior MBSs issued by third parties, exposures to credit institutions. Obligations de Financement de l'Habitat (OFH): First rank mortgages, guaranteed home loans (commercial real estate loans not eligible), state-guaranteed real estate loans, securitisation of the above (subject	The composition of the cover pool depends on the type of covered bond issuer (societe de credit foncier, caisse de refinancement de l'habitat, société de financement de l'habitat). While mixed pools are allowed, most of the existing French covered bond issuers do not apply mixed cover pools. For those who have mixed pools, the pools have remained stable in their composition.	15% of the amount of issued covered bonds.	Yes for OH and OF, no for CRH.



Jurisdiction	Primary asset classes allowed in the cover pool	More detailed information on cover pools	Substitution assets	Derivatives allowed in the cover pool	
	to specific rules). Caisse de Refinancement de l'Habitat (CRH): Home loans to individuals defined by law – first rank mortgages, guaranteed loans.				
Germany	Mortgages, public sector loans, registered ship mortgages, registered liens on registered aircrafts.	The framework permits the issuance of either mortgage or public sector Pfandbriefe, based on a principle of unitary cover. Mixing primary asset types is not allowed. With regard to mortgages, there is no limitation on changing the residential/commercial composition over time. The framework uses the mortgage lending value, which is mostly conservative on commercial properties. In addition, it requires disclosure on the distribution of nominal values of cover assets for residential or commercial use.	20% of the amount of issued covered bonds.	Yes	
Greece	Residential mortgages, commercial mortgages, public sector entities, ship loans, exposures to institutions.	The framework does not provide regulatory limits on the composition of mixed cover pools or measures maintaining consistency of mixed type assets. However, all covered bonds issued already are composed of one primary asset class.	Only allowed as overcollateralisation .	Yes	
Ireland	Residential mortgages, commercial mortgages, public sector loans (depending on the type of issuer), senior MBSs.	The issuers must register as either a credit, commercial or public designated credit institution (DCI). This directly affects the type of primary assets that can be included in the cover pool, whether that be residential mortgages, commercial mortgages or public sector loans, corresponding to the designation of the DCI. Certain other assets can be included in the pool but such assets are subject to specific limits (this includes a requirement that cover pools comprising residential mortgages may include commercial mortgages up to a maximum of 10% of the cover pool). Specifically, eligible assets for the three different types of DCIs are as follows: Mortgage DCIs – Residential mortgage loans, commercial mortgages up to a maximum of 10% of the cover pool assets may also be included, and senior MBSs issued by third parties or the group (subject to credit quality step (CQS) 1 and limited to 10% of the nominal or principle amount of the outstanding mortgage covered securities issued). Commercial mortgage DCIs – Commercial mortgage loans, and senior MBSs issued by third parties or the group (subject to CQS 1 and limited to 10% of the nominal or principle amount of the outstanding commercial mortgage covered securities issued). Public DCIs – Exposures to public entities in and outside the EEA, subject to specific conditions.	15% of the amount of issued covered bonds.	Yes	
Italy	Residential mortgages, commercial mortgages, public sector loans, and senior MBSs.	The issuers decide the composition of cover pools on their own in order to define it, taking into account the different risk profiles of investors. Therefore, the Italian covered bond framework does not include regulatory limits on the composition of mixed asset cover pools. However, where limits in the composition of mixed asset cover pools are established by voluntary contractual arrangements, the consistency and stability of such mixed asset cover pools must be ensured throughout the life of the associated covered bond, also by means of mandatory disclosure under Article 129 of the CRR. Restrictions are applicable on the primary asset classes (this includes a requirement with regard to senior MBSs that must have underlying exposures represented (at least 95%) by the other primary assets).	15% of cover assets.	No rule	
Luxembourg	Residential mortgages, commercial mortgages, public sector loans, MBSs, exposures to credit institutions, aircraft loans, ship loans, other movable assets.	The cover pool must contain one of the following primary asset classes: residential mortgages, commercial mortgages, public sector loans, mortgage-backed securities, exposures to credit institutions, aircraft loans, ship loans and other movable assets. Mixing of primary assets is not allowed. An issuer can apply for a combination of residential and commercial mortgages. The legislation provides for measures to maintain consistency for all eligible asset types of cover pools	20% of the amount of issued covered bonds.	Yes	



Jurisdiction	Primary asset classes allowed in the cover pool	More detailed information on cover pools	Substitution assets	Derivatives allowed in the cover pool	
		throughout the life of the associated covered bonds. For example, the special statutory auditor shall ensure that the collateral to be provided is duly furnished and registered, that its value is in the prescribed amount and that it continues to exist.			
Netherlands	Residential mortgages, commercial mortgages, public sector loans, liens on ships, other assets.	The cover pool must contain one of the following primary asset classes: residential mortgages, commercial mortgages, public sector loans, liens on ships and other assets. An issuer can apply for a combination of residential and commercial mortgages provided that it commits itself to a fixed relationship between these types of cover assets.	20% of the amount of issued covered bonds.	Yes	
Norway	Residential mortgages, commercial mortgages, public sector loans, loans secured on other registered assets.	The cover pool can be composed of residential mortgages, commercial mortgages, public sector loans, loans secured on other registered assets (subject to further regulations) and derivative contracts. The framework allows mixed pools. With a few exceptions, all of the specialised covered bond issuers only use residential mortgages in the cover pool (covered bonds from the issuers using commercial or public sector loans constitute no more than 3% of the total outstanding volume of covered bonds).	20% of cover assets.	Yes	
Poland	Mortgages, public sector loans.	Only two types of primary asset classes are allowed, being either mortgages or public sector loans. Combining the two types of assets is not allowed. There is, however, no prescription for maintaining the consistency of mortgage cover pools between residential and commercial mortgages. The mortgage loans have to be no less than 85% of the nominal value of covered bonds—i.e. maximum 15% can be formed by the substitution assets. There is an analogous requirement for public sector covered bonds. In addition, receivables secured by mortgages established on buildings that are under construction may not (intotal) exceed 10% of the overall value of mortgage-secured receivables in the cover pool.	15% of the amount of issued covered bonds.	Yes	
Portugal	Mortgages (residential and commercial), public sector loans.	Only mortgages (both residential and commercial) or public sector loans are allowed as a primary asset class in the cover pool; the framework does not allow for mixing these primary assets into one single pool. With regard to mortgage pools, it is legally admissible to mix residential and commercial mortgages in one pool. No measures are applied so as to ensure consistency of mortgage pools. In practice, the cover pool is comprised of only one asset type.	20% of cover assets.	Yes	
Romania	Mortgages (residential and commercial).	The cover pool is restricted to mortgages (both residential and commercial). The framework provides that the issuer must determine the proportion between claims secured by residential property and claims backed by commercial property, with the condition to maintain this proportion throughout the life of the covered bonds. Furthermore, other regulatory limits are applicable on the composition of the mixed-asset type cover pool (mortgages on land without construction and on buildings under construction shall not exceed 10% of the value of residential mortgages, and mortgages on land without construction shall not exceed 1% of residential mortgages).	20% of cover assets.	Yes	
Slovakia	For mortgage bond: Mortgages (residential only). For municipal bond: Public sector (municipality) mortgages only.	The composition of the cover pool is restricted to mortgages (residential mortgages for mortgage bonds, and public sector (municipality) mortgages for municipal bonds). Mixing of these asset classes in one cover pool is not allowed. Mortgages must comprise at least 90% of the cover pool.	10% of the amount of issued covered bonds.	No	
Slovenia	For mortgage bond: Residential mortgages and commercial mortgages. For municipal bond: Public sector loans.	Two types of primary asset classes are allowed, depending on the type of the covered bond: mortgages (for mortgage bonds) and public sector loans (municipal bonds). Mixing of primary assets is not allowed. The primary asset class for mortgage bonds can comprise both residential and commercial mortgages; however, commercial mortgages may comprise no more than 20% of the cover assets.	20% of cover assets.	Yes	
Spain	For CH: Mortgages (entire portfolio). For CH:	The characteristic of the CH instrument is such that the cover pool comprises either the entire issuer's mortgages (in the case of CH) or public sector loans (in the case of cédulas territoriales (CT)). In case of	5% of the issued capital.	Yes for CH, no rule for CT	



Jurisdiction	Primary asset classes allowed in the cover pool	More detailed information on cover pools	Substitution assets	Derivatives allowed in the cover pool
	Public sector loans	CH, residential and commercial mortgage loans are not differentiated in the context of the evolution of the cover pool: however, as the cover pool is comprised of the entire issuer's mortgage portfolio, the evolution of the cover pool throughout the life of the covered bonds is not considered to have a big impact on the guarantee granted.		
Sweden	Mortgages, public sector loans.	The cover pool can be composed of mortgages and public sector loans. While the framework allows for mixed pools, it sets out regulatory limits on the composition of such mixed pools according to which commercial loans may constitute up to 10% of the cover pool. There are also restrictions applicable on asset quality.	Max 20% of cover assets.	Yes
United Kingdom	For single asset type programmes: Residential mortgages, commercial mortgages, public sector loans. For mixed asset type programmes: Assets meeting the eligibility criteria referenced in Article 129 of the CRR.	Issuers must designate their covered bond programmes as either a mixed or single asset class programme. Where the designation is single asset class, the cover pool may comprise only one of the following: residential mortgages, commercial mortgages or public sector loans. This initial designation needs to be respected throughout the life of the programme. At present, all regulated covered bond issuers have designated their programmes as single asset programmes, specifically residential mortgage assets. The potential risk of changes to the composition of the cover pool is also addressed through regulatory stress tests.	No rule, 10% in most cases to date.	Yes



Best practice 3 – B: Cover pools with underlying assets located in different jurisdictions

Best practice 3 – B: Cover pools with underlying assets located in different jurisdictions

The legal/regulatory covered bond framework should ensure that cover pools are generally limited to comprising of assets located in the EEA, as this ensures that liquidation of collateral in the case of the issuer's insolvency is legally enforceable.

In the case of cover assets that are loans secured by mortgages on residential or commercial property located in a non-EEA jurisdiction, it should be assessed that the requirements provided in Article 208(2) of the CRR are met and that the priority claim of the covered bond investor is legally enforceable in a scenario of the issuer's insolvency in the jurisdiction under consideration. For cover assets other than mortgages, it should be similarly ensured that access to the cover assets is legally enforceable. Underwriting standards should be similar to the ones applied on comparable loans granted in EEA jurisdictions, and the loans should have similar risk characteristics.

In addition, non-EEA jurisdictions should apply prudential supervisory and regulatory requirements at least equivalent to those applied in the EU, as per Article 107(4) of the CRR.

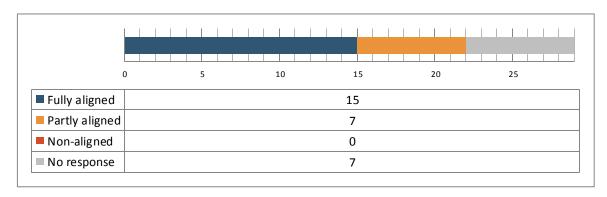


Figure 10: Member States' alignment with best practice 3 – B

For the purposes of this best practice, the geographical location refers to the legal location of the underlying asset in the case of mortgage cover assets and to the legal location of the underlying obligor in the case of cover assets other than mortgage cover assets.

In its 2014 EBA report, the EBA identified prudential concerns related to exposures outside the EEA when a respective jurisdiction's overall regulatory and supervisory framework has not been assessed as equivalent to that of the EU, where loans under consideration have not been underwritten according to similar standards, and where loans feature similar risk characteristics if compared to comparable loans granted in EEA jurisdictions.

A critical consideration in this regard is an overall robustness of the regulatory covered bond framework in the host jurisdiction in terms of integrating the dual recourse principle, ensuring preferential treatment and preferential claims to proceeds from cover assets and establishing a



robust legal position for covered bond investors (without discriminating/differentiating between the foreign and the domestic ones).

Full alignment

With respect to this practice, a large number of jurisdictions are self-assessed as fully aligned (15 in total). The EBA, however, observes a relatively high level of heterogeneity in the regulatory rules applicable to cover assets located outside the EEA in individual jurisdictions:

- Some jurisdictions fully restrict the geographic location of cover assets to the EEA (the Czech Republic and Finland) or limit the geographical scope to the EEA with regard to the primary assets while substitution/other assets are allowed to be located outside the EEA (Belgium and Sweden);
- Some jurisdictions (Austria, Cyprus, Denmark, Greece, Italy, the Netherlands, Romania, Slovenia and Spain) allow for cover assets to be located within jurisdictions outside of the EEA whose supervisory and regulatory requirements have been assessed as equivalent by the Commission or where—based on self-assessment by the individual jurisdictions—regulatory arrangements are in place to provide assurance that the cover assets are enforceable in the respective jurisdictions and/or that underwriting standards and prudential supervisory and regulatory requirements are equivalent or at least comparable to those applied within the EU. It is to be noted that the level or detail and extent of requirements in this regard vary significantly from one jurisdiction to another;
- The geographical scope of cover assets is stricter than the recommendation set out in the EBA's best practice: this is the case for Slovakia (which only allows domestic mortgages and public sector (municipal) loans to be included in the cover pool) and Portugal (which only allows for the assets to be located within the EU).

Partial alignment

Seven countries are considered partially aligned (France, Germany, Ireland, Luxembourg, Norway, Poland and the United Kingdom) due to the fact that the regulatory framework does not limit the geographical scope to the EEA—i.e. it allows extension to other countries. There are, however, generally restrictions and conditions that apply to assets located in non-EEA countries. These do not necessarily relate to the legal enforceability of the cover assets/dual recourse and the underwriting standards; alternately, they are part of supervisory processes rather than the regulatory framework (they may include, for example, restrictions in the form of CQSs and percentage exposures on countries outside the EEA or require assurance of preferential status in the case of the issuer's insolvency when cover assets in the cover pool located outside the EU are in excess of certain percentage thresholds).

No alignment

No jurisdictions have been assessed as non-aligned with the EBA's best practice.



Figure 11: Limitations/conditions on the geographical scope of underlying assets/obligors

Jurisdiction	Limitations/conditions on the geographical scope of underlying assets/obligors
Austria	Both primary and substitution assets are limited to the EEA and Switzerland.
Belgium	Primary asset dasses are limited to the EEA. The geographical restriction for exposures to credit institutions and derivatives is within OECD. As an additional safeguard, non-domestic assets are only eligible assets and count for the overcollateralisation and liquidity test if the applicable non-domestic law does not impede the rights of the covered bondholders to have full recourse to the underlying collateral.
Cyprus	Geographicals cope of cover assets covers the EEA and Switzerland. The EEA (mortgage pools): The EEA, Switzerland, the United States, Canada, Japan, other countries CQS 1 (public sector loans).
Czech Republic	Geographical scope is limited to the EEA.
Denmark	Provision of loans secured by assets outside of Denmark, the Faroe Islands and Greenland require pre-approval from the supervisory authority. The authority makes an evaluation on the suitability of allowing assets to be located in the requested jurisdiction, particularly with respect to legal enforceability and comparability of asset quality in the context of the application process. The national framework also grants the supervisory authority powers to decrease the lending limit so as to reduce risks.
Finland	Geographicals cope is limited to the EEA.
	Different geographical s copes apply to different types of covered bonds:
France	 For OF – Geographical scope for public sector assets is France, multilateral development banks, the EEA, Switzerland, the United States, Canada, Japan, New Zealand, Australia and other juris dictions rated at least CQS 1;
	 For OFH – France, the EEA or a jurisdiction benefiting from the highest level of credit assessment; For CRH – The EEA (by-law restricts the geographical scope to France and overseas territories only).
Germany	It is required that, for cover assets outside the EU (in excess of certain thresholds), the preferential status of covered bond investors must be ensured in the case of the issuer's insolvency or a daim for indemnification for sequestration of such assets vis-à-vis a public sector entity of high credit quality – typically a state-sponsored export credit agency – must exist for the benefit of the covered bond programme and be registered to the cover pool (the thresholds are: 10% of cover assets for mortgage and public sector covered bonds, and 20% of cover assets for ship and aircraft covered bonds). Furthermore, the cover asset eligibility criteria require that foreign security interests have to provide security comparable to German mortgages and, in the case of ship and aircraft covered bonds, it is also required that legal action is not made significantly more difficult for foreign investors (i.e. the German covered bond issuer) compared to domestic ones.
Greece	The loans secured by mortgages can be included in the cover pool if the mortgage is governed by Greek law. Before an asset governed by non-domestic law can be considered eligible for being included in the cover pool, a legal confirmation must be conducted concerning legal validity, binding effect and enforceability under the relevant jurisdiction of the collateral.
Ireland	The framework sets certain restrictions to assets located in non-EEA jurisdictions, and the Central Bank of Ireland also has discretions to issue, for example, regulations and regulatory notices further prescribing requirements that a DQ must comply with when maintaining its cover assets pool. The framework groups non-EEA jurisdictions into 'category A' and 'category B' jurisdictions. Category A jurisdictions are Australia, Canada, Japan, New Zealand, Switzerland and the United States and any other country that the Minister for Finance may designate (by Ministerial order) as a category A jurisdiction. Category B jurisdictions (which may not be included in the cover pools of mortgage and commercial DCIs) are those that are neither EEA nor Category A, and (i) a refull members of the OECD and (ii) have not rescheduled their external debt at any time during the immediately preceding 5 years. Assets located in category A jurisdictions may be included in cover pools.
Italy	Geographical scope of cover assets covers the EEA and Switzerland.
Luxembourg	Geographical scope is limited to the EEA, OECD and other countries CQS 1 (limited to 50% of cover pool) or CQS 2 (limited to 10% of cover pool). The pledge or lien over movable and immovable properties located in these countries must be registered in a public register in these countries and enforceable against third parties.
Netherlands	The scope is restricted to the EEA or a third-party country considered by the Commission (based on



Jurisdiction	Limitations/conditions on the geographical scope of underlying assets/obligors							
	Artide 107(4) of the CRR) as a country having in place supervisory and regulatory requirements at							
	least equal to those of the EU.							
Norway	Geographical scope covers the EEA and OECD jurisdictions. Where loans are granted or acquired, the							
Norway	central authorities in the country where the collateral is present shall qualify for CQS 2 or better.							
Poland	Mortgage covered bonds can be collateralised by cover assets located in Poland only. Public sector							
Polatiu	covered bonds are limited to cover assets with obligors incorporated in the EU and the OECD.							
Portugal	The regulatory framework restricts the geographicals cope of the cover pool to the EU.							
	The scope is restricted to the EEA or a third country subject to restrictions (i.e. the maximum limit of							
	mortgage daims from third countries to be included in the cover pool cannot be higher than 10% of							
Romania	the value of mortgage daims in the cover pool). In addition, the issuer must observe the provision of							
	Article 208(2) and submit its policy on the inclusion (in the cover pool) of loans for the purpose of							
	property investment in a third country to the central bank.							
Slovakia	Covered bonds can be collateralised by cover assets located in Slovakia only.							
Slovenia	Geographicals cope of cover assets covers the EEA and Switzerland.							
	The scope is not restricted to the EEA; however, the mortgage loan assets for CH located outside the							
Spain	EU have to be considered equivalent to mortgage loan assets located in Spain. This is subject to the							
Spain	condition that their legal enforceability is equivalent to that of Spanish assets. For this purpose, a							
	specific assessment of each jurisdiction's legal framework is carried out beforehand.							
Sweden	Mortgage loans in the cover pool are limited to the EEA. Sovereigns outside the EEA are allowed as							
Sweden	counterparties to assets in the cover pool and to substitute cover assets.							
	Cover assets are restricted to being located within Switzerland, the United States, Japan, Canada,							
United	Australia, New Zealand, the Channel Islands and the Isle of Man. For non-EEA assets, issuers are							
Kingdom	required to obtain local legal advice on the enforceability of loans and security, as well as on the							
	perfection of security and priority.							



Best practice 4 – A: LTV limits

Best practice 4 – A: LTV limits

The legal/regulatory covered bond framework should establish maximum LTV parameters to determine the percentage portion of the loan that contributes to the requirement for coverage of liabilities of the covered bond programme (soft LTV limits).

While the EBA sees merits in the LTV limits being not only coverage limits (soft LTV limits) but also eligibility limits (i.e. limits whose breach determines the full non-eligibility of the loan for inclusion in the cover pool, also referred to as 'hard LTV limits') when a given loan is included in the cover pool for the first time, the EBA is concerned about the ongoing application of eligibility LTV limits to loans already included in the cover pool. A severe downturn of real estate prices in the presence of hard LTV limits may determine coverage disruptions in covered bond programmes.

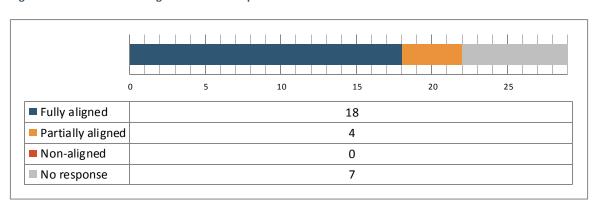


Figure 12: Member States' alignment with best practice 4 - A

The coverage of the cover pool—which Artide 52(4) of the UCITS Directive explicitly requires to be guaranteed for the whole period of validity of the bonds—is strictly connected to the LTV performance of cover assets and, therefore, to the ongoing application of the LTV requirement. Besides establishing the general coverage principle, there are no LTV limits set out in the UCITS Directive that should be applied to all covered bonds (the LTV limits are set out in the CRR and need to be applied by covered bonds seeking preferential treatment).

Two types of the LTV limits should be distinguished: (i) soft or coverage LTV limits (i.e. the limits that determine the portion by which the loan is contributing to the coverage of liabilities attached to the covered bonds); (ii) hard or eligibility LTV limits (which determine the eligibility of the loan for its inclusion in the cover pool or exclusion from the cover pool). In the case of applying the soft limits, the loans with higher LTV limits can be kept in the cover pool; however, soft LTV limits set out the maximum amount by which the loan contributes to the coverage.

In the case of applying hard limits, the loans with higher-than-prescribed hard LTV limits are not eligible for being kept in the cover pool and cannot contribute to the coverage at all. Hard LTV limits can be applied either at the inclusion of the mortgage loan in the cover pool or during the whole existence of the loan. In the second case, once the loan breaches the hard LTV limits (such



as in the case of a decrease in the property value), it is usually taken out of the cover pool (or kept in the cover pool but excluded from the coverage) to be subsequently replaced with an eligible loan or a supplementary asset. The CRR does not specify whether the LTV limits are to be applied on a soft or a hard basis.

Full alignment

There is a very high level of alignment with the identified best practice (altogether 18 jurisdictions). This means that an overwhelming majority of jurisdictions across the EU apply the LTV limits on the mortgage loans they grant. The EBA, however, observes that there is a high level of diversity between the LTV policies applied in individual jurisdictions.

It has been observed that mortgage loans can be collateralised by different types of assets, including—in most cases—residential and commercial mortgage loans, but also by ship loans, aircraft loans, loans on agriculture properties, and other type of loans.

In most jurisdictions, the different types of assets are assigned different LTV ratios in acknowledgment of different default risks linked to these asset dasses. In most jurisdictions, the covered bond frameworks distinguish between LTV for residential and commercial mortgages; only a limited number of jurisdictions set out uniform LTV levels for these two types of loans. Three jurisdictions also distinguish LTV limits for other asset dasses (Cyprus for ships, Germany for ships and aircrafts, and Sweden for properties used for agriculture).

The LTV limits are normally set out at the same percentage limits as prescribed by the CRR (i.e. 80% for residential mortgages and 60% for commercial mortgages). In a few jurisdictions, the framework allows the possibility of applying higher LTV limits in specific circumstances, normally for residential mortgages (i.e. in the case of high overcollateralisation or if the loan is backed by a guarantee or insurance).

Frameworks in 10 jurisdictions establish soft LTV limits—i.e. LTV limits that determine the portion of the loan that can be taken into account for the coverage calculation requirement. These jurisdictions include Belgium, France, Germany, Greece, Ireland, Luxembourg, the Netherlands, Sweden, Slovenia and the United Kingdom. The majority of these jurisdictions explicitly establish the LTV percentages, while a minority of them make reference to LTV limits as set out in Article 129 of the CRR.

Eight jurisdictions allow the application of both soft and hard limits (hard limits at the inclusion of the loan in the pool and/or during the life of the loan), while the rules differ considerably between individual frameworks. These include: the Czech Republic, Denmark, Finland, Italy, Poland, Portugal, Romania and Norway. For the purposes of this assessment, all these jurisdictions have been assessed as fully aligned, as their framework incorporates soft LTV limits.

No jurisdictions apply maximum soft LTV limits (i.e. maximum LTV ratios of the contribution of the individual loans to the coverage).



Specific LTV frameworks are applicable in Denmark. In case of this jurisdiction, differentiation is made between the specialised mortgage credit institutions and universal banking models. For specialised mortgage credit institutions, there is a hard LTV limit applied at the inclusion of loans in the cover pool—i.e. only loans within the LTV limit can be placed in the cover pool. In addition, soft LTV limits apply during the existence of the loan: in the case of LTV limit breaches loans cannot be taken out of the cover pool and issuers are required to add additional security in the form of supplementary collateral. Ineligible collateral cannot be taken out of the cover pool, as the whole issuer's balance sheet is financed within the covered bond arrangement. In contrast to specialised institutions, issuers operating under the universal modelhave the possibility of taking the loan out of the cover pool during the lifetime of the loan and replacing it with an eligible loan.

Partial alignment

There are four jurisdictions that are considered partially aligned, as their frameworks do not apply soft LTV limits but hard LTV limits only (Austria, Cyprus, Slovakia and Spain).

Cyprus introduces hard limits (75% for residential mortgages, 60% for commercial mortgage and 60% for ship loans). Austria hosts three covered bond frameworks. In one framework (the HypBG), a hard LTV limit is in place (60%) while under the other two frameworks (PfandBG and FBSchVG), no maximum LTV limit rule is in place. However, the authorities intend to introduce a consistent LTV requirement at the level of 60% throughout the existing legislation.

In Slovakia, the hard LTV limit of 70% is applied at the inclusion of the loan in the cover pool. Furthermore, the framework allows that loans exceeding the 70% limit are added to the cover pool; the total amount of such mortgage loans exceeding the 70% limit may not surpass 10% of the total amount of mortgage loans.

In the case of Spain, the framework distinguishes between cover assets and eligible assets. Cover assets consist of the entire mortgage loan book, and there are no LTV limits applied to them. Part of the cover assets is formed by eligible assets for the purpose of determining the amount of CH that can be issued. There are restrictions applicable to the eligible assets, including the LTV soft and hard limits (60% for commercial mortgages and 80% for residential mortgages, while the latter can be increased to 95% under certain circumstances—i.e. in case the loan is covered by a guarantee or insurance).

No alignment

No jurisdictions are assessed as non-aligned with the EBA's best practice on LTV limits.



Figure 13: Overview of the LTV limits applied in individual jurisdictions

Jurisdiction	Type of LTV limit	Details of the LTV limit
Austria	Hard/no LTV limits	HypBG framework: Hard LTV limits of 60%. PfandBG and FBSchVG frameworks: No LTV limits .
Belgium	Soft LTV limits	80% for residential mortgages, 60% for commercial real estate.
Cyprus	Hard LTV limits	75% for residential mortgages, 60% for commercial mortgages, 60% for ships.
Czech Republic	Soft + hard LTV limits	Soft limits: 70% (applied on an aggregated basis—i.e. at the level of the issuer) Hard limits: 200%.
Denmark	Soft + hard LTV	Specialised mortgage credit institutions: Hard limits at the inclusion of the loan in the
	limits + demand for	cover pool, soft LTV limits during its lifetime (handled by additional security).
	additional security	Universal institutions: Hard limits at inclusion of the loan in the pool and soft limits
		during its lifetime (handled by additional security and possibility to remove the loan in
		breach of LTV limits from the cover pool)
Finland	Soft + hard LTV	Soft + hard LTV limits (applied at the inclusion of the loan in the pool):
	limits	70% for residential mortgages, 60% for commercial mortgages.
		Furthermore, an additional hard LTV limit of 100% is applied during the life of the
		programme—i.e. loans of 100% LTV shall be excluded from the cover pool; loans with
		LTV between 60/70% and 99% are allowed to stay in the cover pool.
France	Soft LTV limits	OFH: 80% for first-rankresidential mortgage loans and guaranteed home loans, 100%
		for state-guaranteed real estate loans.
		OF: 80% for first-rank residential mortgage loans and guaranteed home loans, 60%
		for first-rank commercial mortgage loans, 100% for state-guaranteed real est. loans.
		CRH: 80% for residential mortgage loans (90% if there is an overcollateralisation of
		25%), 100% for state-guaranteed mortgage loans.
Germany	Soft LTV limits	60% for each of mortgage, ship and aircraft loans.
Greece	Soft LTV limits	Reference to Article 129 of the CRR.
Ireland	Soft LTV limits	75% for residential mortgages, 60% for commercial mortgages.
Italy	Soft + hard LTV	80% for residential mortgages, 60% for commercial mortgages.
,	limits	Hard limits apply at the inclusion of the loan in the coverpool. Whenever the LTV
		threshold is not met for a specific loan already included in the cover pool, the issuer
		shall alternatively: substitute the asset with a loan that complies with the eligibility
		criteria, reduce the amount of the loan computable in the cover pool in order to
		respect the LTV limit and, if needed, add new eligibility loans.
Luxembourg	Soft LTV limits	60% for commercial mortgages, 80% for residential mortgages.
Netherlands	Soft LTV limits	Reference to Article 129 of the CRR.
Norway	Soft + hard LTV limit	Soft LTV limits + hard LTV limits (applicable at the inclusion of the loan in the pool):
No. way	Sole : Hara Er v IIIII.e	75% for residential mortgages, 60% for commercial mortgages.
Poland	Soft + hard LTV	Soft limits: 60% for commercial mortgages, 80% for residential mortgages.
	limits + additional	Hard limits (applied at the moment of granting the loan or at the moment of
	LTV limits	acquiring the loan from a third party): 100%.
		Additional requirement: Total amount of mortgage loans, in the part exceeding 60%
		of the value of properties, may not surpass 30% of the total bank's mortgage loans.
Portugal	Soft + hard LTV	80% for residential mortgages.
J	limits	60% for commercial mortgages.
		If these limits and requirements are breached, the issuer is legally required to remedy
		the situation immediately by (i) allocating new mortgage credits (with or without
		replacing the credits which LTV was breached), (ii) purchasing outstanding covered
		bonds in the secondary market and/or (iii) allocating other eligible replacement
		assets within the set legal limits. The LTV limits apply at the initial inclusion of the
		loan on the cover pool, as well as on an ongoing basis. However, since the issuer has
		the possibility of removing (or not) the credits affected by a LTV excess, these limits
		can be considered to be both hard and soft (at the issuer's discretion).
Romania	Soft + hard LTV	Reference to Article 129 of the CRR.
	limits	Hard limits are applied when a loan is included in a cover pool.
Spain	Hard LTV limits	60% for commercial mortgages.
- -		80% for residential mortgages (or 95% if the mortgage loan has a bank guarantee
		provided by a different credit institution to the investor or is covered by credit
		insurance).
Sweden	Soft LTV limits	75% for residential mortgages, 70% for properties used for agriculture, 60% for
	55.02.7.1111105	commercial mortgages.
Slovakia	Hard LTV limits +	Hard LTV limits of 70% applied at the inclusion of the loan in the cover pool
Slovakia	Hard LTV limits + additional LTV limits	Hard LTV limits of 70% applied at the inclusion of the loan in the cover pool. Additional requirement: Total amount of mortgage loans exceeding the 70% limit that
Slovakia	Hard LTV limits + additional LTV limits	$Additional\ requirement: Total\ amount\ of\ mortgage\ loans\ exceeding\ the\ 70\%\ limit that$
Slovakia		Additional requirement: Total amount of mortgage loans exceeding the 70% limit that can be added to the cover pool may not surpass 10% of the total amount of the
Slovakia		$Additional\ requirement:\ Total\ amount\ of\ mortgage\ loans\ exceeding\ the\ 70\%\ limit that$



Best practice 4 – B: LTV measurement and frequency of revaluation

Best practice 4 – B: LTV measurement and frequency of revaluation

The legal/regulatory covered bond framework should establish that the value of the property securing a particular loan and the corresponding regulatory LTV limit determining the contribution of that loan to the coverage requirement be monitored and updated (e.g. at least via an indexation or other statistical method) on at least a yearly basis for both residential and commercial properties, and more frequently where either the management of the covered bond programme, the cover pool monitor or the competent authority deem appropriate.

The framework should specify that the valuation of the properties securing the loans should be based on transparent valuation rules and be carried out by an agent who is independent from the credit granting process. As a minimum, the valuation process should be compatible with the conditions laid down in the first and second sub-paragraphs of Article 229(1) of the CRR.

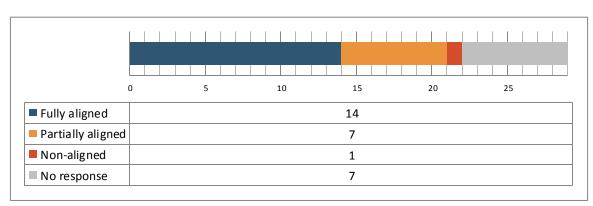


Figure 14: Member States' alignment with best practice 4 – B

In addition to ensuring that mortgage loans comply with LTV limits, the measurement of the value and frequency of the revaluations of the properties are also important factors impacting the coverage requirement. The CRR prescribes the frequency of the revaluation in Article 208(3), according to which it must take place (as a minimum) once every year for commercial immovable property and once every 3 years for residential properties. The EBA recommended, in its best practice, that the revaluation should take place yearly for both residential and commercial properties. It should be noted that revaluation performed on a statistical basis (i.e. through indexation benchmarks and automated valuation models) has been considered as a valid method.

Full alignment

The following 14 jurisdictions are assessed as aligned with the best practice: Belgium, Denmark, Germany, Greece, Finland, France, Ireland, Italy, the Netherlands, Norway, Poland, Portugal, Spain and the United Kingdom. These jurisdictions generally require at least an annual revaluation of both residential and commercial properties and set out provisions ensuring the independence and transparency of the valuation process.



A limited number of these jurisdictions (e.g. Belgium, Denmark, Greece, Italy and Portugal) follow the frequency as established in Article 208(3) of the CRR (i.e. every 3 years for residential properties and every year for commercial properties); however, their regulatory frameworks require a more frequent revaluation in specified circumstances (such as upon deteriorating market indicators) and/or require more frequent monitoring and verification of the valuation of properties to be performed in the context of the duties of the cover pool monitor.

In two jurisdictions (Germany and Poland), the framework establishes the use of mortgage lending value for the valuation of properties securing mortgage loans. In Germany, the assessment of the value of a property is conducted on an ad hoc basis rather than on a regular basis: the inputs of the mortgage lending value calculation have to be reassessed in the case of a non-insignificant deterioration in the base of the assessment or material arrears. Poland has a similar framework in place. The systems in place have been self-assessed as sustainable and long-term valuation concepts, and hence are fully in line with the EBA's best practice.

Partial alignment

Seven jurisdictions are partially aligned with this best practice, these being Cyprus, the Czech Republic, Luxembourg, Romania, Slovenia, Slovakia and Sweden. While these jurisdictions have regulation in place dealing with the revaluation of the properties, the regulations are not necessarily fully aligned with all aspects of the EBA's best practice. In most cases, the frameworks are not aligned with the prescribed frequency of revaluation, while being compliant with the recommendation on the independence and transparency of the revaluation process.

Non-alignment

One jurisdiction is not aligned with the best practice (Austria), as no specific legal requirements exist concerning the valuation and frequency of the revaluation of properties.



Best practice 5: Coverage principles and legal/regulatory overcollateralisation

Best practice 5: Coverage principles and legal/regulatory overcollateralisation

The legal/regulatory covered bond framework should ensure that all the liabilities of the covered bond programme, including liabilities towards counterparties in derivative contracts and (as applicable) liabilities towards managers/administrators, servicers, trustees, cover pool monitors and similar entities involved in the process of covered bond issuance are covered by cover assets.

The EBA considers that a legal/regulatory minimum overcollateralisation level constitutes a regulatory best practice. The recommendation of a quantitative legal/regulatory minimum overcollateralisation level would require further analysis, as it depends on several factors, including—but not limited to—the class of cover assets and, crucially, the chosen coverage principle among the several different coverage principles currently adopted across jurisdictions (nominal, net present value, prudent market value, net present value under stress, etc.).

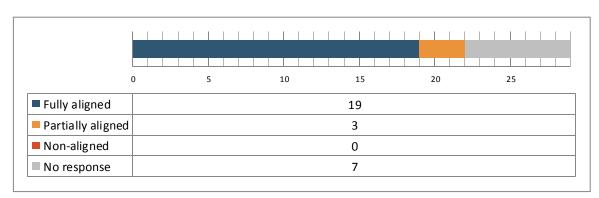


Figure 15: Member States' alignment with best practice 5

Requirement for a minimum level of overcollateralisation is a fundamental method used for mitigating the most relevant risks to which covered bonds are exposed, including liquidity, market, refinancing and operational risk (particularly in case of the issuer's insolvency or resolution). The following assessment only takes account of regulatory overcollateralisation requirements; it does not give account of overcollateralisations stemming from contractual arrangements or applied by issuers on a voluntary basis. In addition, it is noted that, apart from overcollateralisation, other specific forms of coverage are applied by some jurisdictions, such as interest matching, currency matching, duration matching or maturity matching. These are also disregarded in the assessment.

Full alignment

There is a very high level of alignment with this best practice, with all but three responding jurisdictions (Austria, the Czech Republic and Slovakia) being fully aligned. Legal/regulatory frameworks in all these complying jurisdictions incorporate a requirement for a minimum amount of cover assets to be available to cover claims attached to covered bonds during the whole period of validity of these bonds.



There exists a wide range of minimum overcollateralisation levels (i.e. minimum excess of cover assets over liabilities) across jurisdictions, up to 25%. Those jurisdictions that require the minimum overcollateralisation to be at a level that is higher than 0% are assessed as fully compliant, enabling the issuers to fully cover all liabilities attached to covered bond programmes.

Covered bond frameworks in two jurisdictions (Italy and Norway) require issuers to maintain a positive (although not qualified) overcollateralisation level (i.e. a level greater than 0%). They are considered aligned with the best practice, as other requirements are in place that effectively ensure the value of overcollateralisation is, in practice, above 0% and hence able to cover liabilities of the covered bond programmes, including liabilities towards derivative counterparties and operational costs related to the programme.

In Denmark, the framework for the specialised covered bond issuers incorporates a capital requirement for a minimum of 8% risk-weighted assets to be met by each individual cover pool, as well as by the issuering eneral, which is considered an overcollateralisation requirement of 8%.

The EBA notes that there exist a number of methods that are used for the calculation of the overcollateralisation requirement. The three most widely used methods are the following:

- Calculation based on the nominal value, according to which the total nominal amount of all
 assets in the cover pool shall always be at least as high as the total nominal amount of
 outstanding covered bonds. This method is applied in the majority (nine) of jurisdictions:
 Austria (for HypBG and PfandBG), Belgium, France, the Netherlands, Poland, Portugal, Spain,
 Slovakia and the Czech Republic (it should be noted that Austria, the Czech Republic and
 Slovakia are assessed as partially aligned with this best practice);
- Calculation based on the net present value, according to which the net present value of all assets in the cover pool shall always be at least as high as the net present value of all outstanding covered bonds. This criterion implies the use of a yield curve for discounting future cash flows. It is applied in three jurisdictions (Cyprus, Finland and Romania);
- Calculation based on the net present value under stress, according to which the net present
 value of all assets in the cover pool shall always be at least as high as the net present value of
 all outstanding covered bonds and the condition should hold even following the
 implementation of stress conditions, based on static or dynamic simulations. This method is
 applied in one jurisdiction (the United Kingdom).

A number of jurisdictions use combinations of various methods (such as Germany, Greece, Italy, Luxembourg, Romania, Slovenia and Sweden), usually combining calculations based on both nominal value and net present value, or net present value and net present value under stress, or other combinations.

Three jurisdictions use specific methods: prudent market value used in Ireland and Norway and combination of nominal and risk-weighted value methods used in France.



Partial alignment

Three jurisdictions are considered as partially aligned with the EBA's best practice (Austria, the Czech Republic and Slovakia).

In Austria, two of the three regulated covered bonds (the PfandBG and HypBG) require an overcollateralisation of 2% of the nominal value of covered bonds, whereas under the FBSchVG framework, no legal requirement currently exists. The authorities intend to extend the overcollateralisation requirement to the FBSchVG.

In the cases of the Czech Republic and Slovakia, the regulatory frameworks establish a minimum overcollateralisation of 0%, as they require that the total nominal amount of all cover assets shall always be at least as high as the total nominal amount of the outstanding covered bonds.

No alignment

No jurisdictions are assessed as non-aligned with the EBA's best practice.

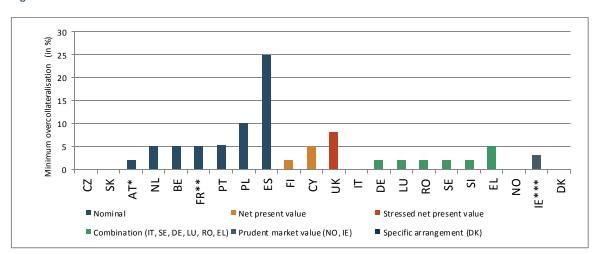


Figure 16: Minimum overcollateralisation levels across Member States

^{*}IN AUSTRIA, 2% APPLY FOR TWO COVERED BOND FRAMEWORKS, AND THERE IS NO LEGAL REQUIREMENT FOR THE OTHER FRAMEWORK.

^{**} IN FRANCE, 5% AND 25% ARE APPLICABLE.

^{***} IN IRELAND, 3% AND 10% ARE APPLICABLE.



Figure 17: Overcollateralisation requirements across Member States

Jurisdiction	Method for calculation of overcollateralis ation	Overcoll ateralis ation	Further information/requirement on overcollateralisation
Austria	Nominalvalue	2%	HypBG and PfandBG: 2% of the nominal value of the covered bonds in circulation. FBSchVG: No legal requirement for a minimum overcollateralisation.
Belgium	Nominal value	5%	First, the value of eligible assets (residential mortgages, commercial mortgages, public loans, exposures to credit institutions) must be always higher than 105% of outstanding covered bonds. Exposures to credit institutions may only be considered if they are of highest credit quality (and of a maturity of less than 1 year if applicable) or of CQS 2 if of a maturity shorter than 100 days. Second, the value of cover pool assets in the 'strictest sense' (i.e. residential mortgages, commercial mortgages, or public loans) must be at least 85% of the outstanding covered bonds.
Cyprus	Net present value	5%	
Czech Republic	Nominal value	0%	The total nominal amount of all cover assets shall always be at least as high as the total nominal amount of outstanding covered bonds.
Denmark	Risk-weighted value	8%	Mortgage credit institutions are specialised institutions that grant mortgage credit loans and issue covered bonds in series—i.e. capital centres, each having an individual serial reserve fund. The framework requires that the solvency requirement of a minimum 8% in terms of risk-weighted assets shall be met in each individual serial reserve fund, as well as for the institution in general. This shall be fulfilled with funds qualifying as Common Equity Tier 1 capital, additional Tier 1 capital or Tier 2 capital. The funds of the serial reserve fund remain separate from the other funds of the mortgage credit institution, and the capital centres are upheld in insolvency or resolution.
Finland	Net present value	2%	,
France	Nominal value (for covered bonds), risk- weighted value (for the cover assets)	5%/ 25%	Sociétés de Financement de l'Habitat (SFH) and SCF: 5% CRH: 25% (the higher threshold corresponds to their specific structure, which pools different sponsors within the same issuing entity). The value of the assets within the covered pool to be used is the nominal value times a factor (between 0% and 100%) depending on the nature of the asset and its quality, as stated in the CRBF Regulation N° 99-10. Covered bonds are taken into account at their nominal value.
Germany	Net present value + net present value under stress	2%	Present value (daily) and stressed present value (at least weekly)
Greece	Nominal value + net present value + net present value under stress	5.2632%	5.2632% based on nominal value (as the overall nominal value of mortgage bonds in circulation, plus a ccrued interest, may not exceed 95% of the nominal value of assets in the cover pool, excluding derivatives used for risk hedging purposes) 0% based on net present value, including derivatives used for risk hedging purposes. 0% based on net present value under stress, including derivatives used for risk hedging purposes. Furthermore, during a 12-month period, the amount of interest payments to bond investors may not exceed the amount of interest that is expected to be received on the assets of the cover pool in the same period. This check shall also encompass financial derivatives used for hedging purposes.
Italy	Nominal value + net present	0%	The assets must be (at a minimum) equal to covered bonds based on the nominal value as well as net present value.



Jurisdiction	Method for calculation of overcollateralis ation	Overcoll ateralis ation	Further information/requirement on overcollateralisation
	value		Furthermore, interests owed on cover assets must be at least equal to interests owed on covered bonds. Higher levels of over collateralisation are usually provided on a voluntary basis by contractual provisions and, in such a case, must be complied with as they were set in a binding regulation.
Ireland	Nominal value + prudent market value	3%/ 10%	For mortgage DCIs: 3% for residential and 10% for commercial mortgages, after taking into account the effect of any cover assets hedge contract comprised in the cover assets pool. For public DCIs: 3%. Calculation based on prudent market value of mortgage credit assets.
Luxembour g	Nominal value + net present value	2%	2% of both nominal and net present value.
Ne the rland s	Nominal value	5%	5% based on nominal value. 0% based on calculation, taking into consideration the restrictions provided for in Article 129(1)(d) under i, e, f under i and g of the CRR as far as applicable to the type of cover assets used.
Norway	Nominal coverage+ prudent market value	0%	The value of the cover pool shall, at all times, exceed the value of bonds with a preferential claim over the cover pool. Upon inclusion of loans in the cover pool, a prudent value shall be established for the asset furnished as security for each loan. Prudent market value may not exceed the market value resulting from a cautious as sessment.
Poland	Nomi nal value	10%	10% of the nominal value covered bonds.
Portugal	Nomi nal value	5.2632%	The overall nominal value of mortgage bonds in circulation may not exceed 95% of the nominal value of mortgage credits and other assets as signed to the cover pool. That means a mandatory overcollateralisation of 5.2632%.
Romania	Net present value + net present value under stress + accounting value	2%	2% of the net present value of all liabilities arising in the programme. 0% of the net present value under stress scenarios. 0% of the accounting value of all liabilities (i.e. the accounting value of the cover assets needs to be at least equal to the accounting value of the liabilities; a value of derivative contracts is not taken into account).
Slovakia	Nominal value	0%	The total nominal amount of all cover assets shall always be at least as high as the total nominal amount of outstanding covered bonds.
Slovenia	Nominal value + net present value + net present value under stress	2%	2% under the net present value under stress. 2% of the net present value. 0% of the nominal value.
Spain	Nominal value	25%	For CHs: 25% of the nominal value. This is a consequence of the issuing limit ratio by which institutions shall not issue CHs for an amount greater than 80% of the outstanding eligible mortgage loans and credits in their portfolios.
Sweden	Nominal + net present value	2%	2% based on nominal and net present value. Furthermore, the institution must also make sure that the cash flows are such that the payment obligations to the liability holders can, at all times, be fulfilled.
United Kingdom	Net present value under stress	8%	8% of total principal amount outstanding. The coverage principle is net present value under stress. In a ddition, the FCA applies a specific regulatory minimum overcollateralisation level depending on programme features and cover pool characteristics.



Best practice 6 – A: Use of derivatives

Best practice 6 – A: Use of derivatives

The legal/regulatory covered bond framework should specify that derivative instruments are allowed in covered bond programmes exclusively for risk hedging purposes.

The legal/regulatory covered bond framework should provide that derivative contracts entered into by the covered bond issuer with a derivative counterparty and registered in the cover pool cannot be terminated upon the issuer's insolvency.

0 5 10 15 20 25

Fully aligned 17
Partially aligned 3
Non-aligned 2
No response 7

Figure 18: Member States' alignment with best practice 6 - A

Derivative instruments are tools often used in covered bond programmes for the mitigation of market risks, particularly risks stemming from interest and/or currency mismatches. While providing protection to the covered bondholders, they also introduce an element of counterparty credit risk to the structure of the covered bond programmes, as the counterparties usually rank pari passu with the covered bondholders with regard to claims for covered bond assets. In addition, where derivatives are permitted to be used for purposes other than risk hedging, this opens up the possibility of issuers using derivatives in speculative transactions that, in the end, may result in harming the covered bondholders. The EBA has, therefore, recommended that derivative instruments are only allowed to be used for risk hedging purposes and they cannot be terminated when the issuer enters the stage of insolvency, so as to keep providing protection to the covered bond programme in the interests of the covered bond investor.

Besides the use of derivatives, other arrangements are put in place in a number of jurisdictions to address the market risks associated with covered bonds, such as requirements for the eligibility of derivatives' counterparties and limits on intragroup hedging transactions. These are disregarded for the purposes of this assessment.

Full alignment

There is a relatively high level of alignment with the best practice, as 17 jurisdictions have been self-assessed as fully aligned (Austria, Belgium, Cyprus, Denmark, Finland, France, Greece, Ireland, Italy, the Netherlands, Norway, Portugal, Romania, Slovenia, Sweden, Spain and the United Kingdom). Regulatory frameworks in these jurisdictions allow derivatives only for the purposes of



hedging risks, and establish that the derivative contracts in the cover pool cannot be terminated upon the issuer's insolvency.

Partial alignment

Three jurisdictions are considered to be partially aligned (Germany, Luxembourg and Poland). This is due to the national frameworks either not requiring that derivative instruments are only used for risk hedging (Germany) or not requiring that they cannot be terminated in case of the issuer's insolvency (Luxembourg and Poland).

- In Germany, the framework requires that derivative instruments entered into by covered bond issuers are registered in the cover pool and cannot be terminated upon the issuer's insolvency, to the extent that the cover pool derivative shall be taken into account as cover assets. However, no requirement exists to only use derivatives included in the cover pool for risk hedging purposes. It has been clarified that the reason for not establishing this requirement is that it would have to be met at all times, which was deemed impractical in terms of administration (addition and removal of derivatives from the cover pool) and costs of implementation;
- In Luxembourg, the framework allows the issuer to use derivatives to ensure coverage and
 requires the derivatives to be registered in the cover pool. However no specific provision is
 foreseen on the exclusion of a termination of the derivative contract in case of the issuer's
 insolvency;
- In Poland, the covered bond framework requires the issuer to take appropriate measures to mitigate exchange rate and interest rate risks. The derivatives are implicitly registered in the cover asset register and hence are protected from the insolvency of the issuer. There is, however, no explicit requirement that the termination of the derivative contract upon the issuer's insolvency shall not be allowed.

Non-alignment

Two jurisdictions (the Czech Republic and Slovakia) are considered as non-aligned. Their regulatory frameworks do not regulate the use of derivatives explicitly. There are no provisions that would limit the use of derivative instruments for risk hedging only nor the requirement for the derivative contracts to continue in the case of the issuer's insolvency.



Best practice 6 – B: Liquidity buffer

Best practice 6 – B: Liquidity buffer

The EBA considers that a requirement to mitigate liquidity risk in the covered bond programme by means of liquid assets available at all times to cover the cumulative net outflows of the covered bond programme over a certain time frame constitutes a regulatory best practice. Determining the calibration and scope of a best practice requirement would require further analysis, since—as the report acknowledges—different structures of the covered bond programme (e.g. hard bullet, soft bullet and CPT structures) expose the covered bond programme to liquidity risk to different extents.

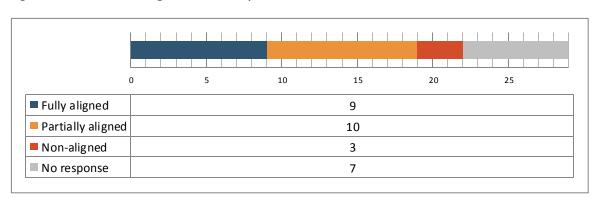


Figure 19: Member States' alignment with best practice 6 – B

With the aim to address in a comprehensive way the different factors behind the occurrence of a liquidity shortage, the EBA recommended the presence of a liquidity buffer. The 2014 EBA report specified that the liquidity buffer (as recommended by the EBA) should be distinct from, and should not be related to, the already existing prudential regulation on liquidity and particularly the LCR provisions applicable to covered bond issuers. While the LCR requirements are calibrated to address a 1-month interval of liquidity stress hitting the covered bond issuer, the objective of the liquidity buffer is to target the needs of the covered bond programme, particularly in the scenario of the issuer's insolvency where the liquidity safeguards of the issuer are no longer available.

For the purposes of the assessment, the EBA only considered requirements on specific liquidity buffers, distinct from the general liquidity requirements. Other measures used to address the liquidity risk—such as interest/maturity matching, overcollateralisation, substitution assets and soft bullet/CPT structures—have been disregarded in the analysis.

Full alignment

The EBA observes that nine jurisdictions have a specific liquidity buffer in place (Belgium, Cyprus, Denmark, France, Germany, the Netherlands, Poland, Romania and Slovenia).

The frameworks in these jurisdictions require the liquidity buffer to be in place to cover outflows due from both principal and interest (in Poland, only interests are covered). Other additional



outflows are covered in some jurisdictions, such as outflows related to derivative financial instruments, or other costs incurred during the issuance. The time frame of the liquidity buffer is usually 6 months (i.e. the outflows for the upcoming 6 months are to be covered) and the type of coverage is full coverage (i.e. the full amount, rather than a portion, is to be covered).

With regard to the contribution of the liquidity buffer to coverage, the substantial majority of jurisdictions allow the buffer to be a part of the cover pool (i.e. part of the cover pool must be sufficiently liquid and generate sufficient liquidity), while the minority requires the buffer to be set on top of coverage requirements.

In Denmark, specialised mortgage credit institutions implement the match funding model, applying a match between the loan and the bonds issues, hence also between payments on the borrower (collateral) side and the investor (bond) side. The borrower knows, at all times, which bond is funding his loan and the loan and the bonds are tied together. When a loan is refinanced, the underlying bonds are replaced and the match funding principle applies continuously. When refinancing takes place, the new interest (irrespective of whether it is higher or lower than the previous interest) is transferred fully to the borrower. The general balance principle relating to liquidity requires at least 10% of the uncalled drawing facilities at all times. As the borrower is contractually obliged to pay interest and instalments before the investors are entitled to receive their payment, this reduces the investors' risk in terms of the credit risk.



Figure 20: Liquidity buffer coverage for due obligations

Jurisdiction	Principal coverage	Interest coverage	Separate from the LCR	Allowed as part of cover pool	More detailed information on the liquidity buffer
Belgium	6 months	6 months	Yes	Yes	Full coverage, for 6 months, including all outflows (principal repayment, interest payments, any other costs to be paid out of the cover pool). The cover pool must generate sufficient liquidity such that all outflows in the relevant time horizon are covered. The issuing bank may also use liquidity facilities as fulfilment of the liquidity requirement, whereas the liquidity line must be for the exclusive use for the cover pool (and not cover any liquidity needs of the issuing institution) and must be provided by a credit institution (not within the perimeter of consolidation of the issuing credit institution) of CQS 1 located within the EEA.
					If a cover pool breaches the liquidity test, the issuing credit institution must take measures within 14 days and is barred from issuing any further covered bonds (under the same or a different programme).
Cyprus	30-180 days	180 days	No	Yes	The coverage requirement increases as the time to payment obligation approaches. For interest and cost obligations, full coverage must be provided 180 days prior to the obligation falling due. Regarding principal repayments, the degree of coverage required is as follows: 50% coverage for principal repayments falling due within 31-180 days; and 100% coverage for principal repayments falling due within 30 days or less. The issuer shall maintain the required liquidity either as a part of the cover pool in the form of complementary assets or outside the cover pool in the form of liquid assets.
France	180 days	180 days	Yes	Yes	The framework requires the SFH and SCF 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. The potential liquidity needs may be covered either by substitution assets (which may consist of up to 15% of the cover pool) or by assets that are eligible for refinancing with the ECB. It is not possible to cover the existing 6-month liquidity gap with intragroup liquidity lines. The framework provides further liquidity means by allowing, as a last-recourse funding option, the SFH and SCF to subscribe to its own privileged covered bonds—up to 10% of total privileged liabilities—provided that the institution uses these covered bonds as collateral with the central bank or cancels them within 8 days.
Germany	180 days	180 days	Yes	Yes	The framework requires the liquidity buffer to be in place in order to cover (based on full coverage and for the next 180 days) payments due of circulated covered bonds' principal and interest. The amount necessary as liquidity buffer is calculated (on a daily basis) as follows: (1) daily netting of cash inflows on cover assets and cash outflows due to principal and interest owed for each of the next 180 days; (2) for each day, summing up all previous daily net amounts including the actuals; (3) largest single negative amount of (2) within next 180 days is the buffer amount necessary. The buffer amount is not necessarily on top of cover assets but a requirement on the liquidity properties of



					cover assets (i.e. a certain amount within coverage has to consist of highly liquid cover assets).
Netherlan ds	6 months	6 months	Yes	Yes	The framework requires a liquidity buffer to cover (for at least the next 6 months) interests, redemption amounts on the outstanding bonds, and other obligations. The framework requires that the issuer either holds sufficient liquid assets or generates sufficient liquid asset via the cover assets.
					The obligation to pay the redemption amounts shall not apply if the owner of the cover asset is entitled to
					defer payment of the redemption amount by at least 6 months compared to the original redemption date.
					When calculating the amount of the liquidity buffer, the expected cash flows from derivative contracts and
					other risk mitigation instruments used for covering these obligations shall be taken into consideration.
Poland	Not covere d	6 months	Yes	No	The framework requires the establishment of a liquidity buffer (separately for mortgage-covered bonds and public sector covered bonds) consisting of an amount of liquid assets (securities issued by governments, central banks, etc., deposited in the central bank or cash) that is no less than the sum of the nominal value of interest due on covered bonds in the following 6 months.
					The amount is excluded from the amount funded by covered bonds—i.e. the surplus has to be maintained independently from the cover bonds register.
Romania	180 days	180 days	Yes	Yes	The framework establishes a 180-day pre-maturity test that requires the issuer to compare—for this period on a daily basis—incoming and outgoing cash flows (generated by the repayment of principal, interest and all the other costs incurred during the issuance) and to ensure that any gaps are fully covered by liquid assets. For this purpose, the liquid assets need to fulfil both of the following conditions: (i) they satisfy the requirements applicable to substitution assets; (ii) they are eligible as collateral for monetary policy operations of the central bank.
Slovenia	180	180	Yes	Yes	The framework requires the following conditions for the liquidity buffer. The maximum liquidity gap (i.e
	days	days			cumulated net cash outflows) calculated on a daily basis for the next 180 days is required to be covered at al times by the liquid assets eligible for the substitute cover assets. The obligations covered are all matured liabilities from derivatives (i.e. interest and principles).



Partial alignment

In 10 jurisdictions, no specific liquidity buffer is required to be established (Greece, Finland, Italy, Ireland, Norway, Spain, Portugal, Slovakia, Sweden and the United Kingdom). However, these frameworks incorporate other measures with the objective to address liquidity risk. One widely used type of measure is the requirement for 'matching' between the duration, maturity, interest or cash flows of assets and liabilities in the covered bond programmes. According to interest rate matching, it is required that the total amount of interest/cash flow payments to covered bond investors shall not exceed the total amount of interest/cash flow received on the assets in the cover pool in a given time frame (usually for the next 12 months). This also usually covers the payments to the counterparties in the derivative contracts and possibly operational costs. According to duration/maturity matching, the duration (or weighted duration)/maturity of covered bonds shall not exceed those of the assets in the cover pool. Finally, currently matching is also used, requiring that both covered bonds and the assets in the cover pool must be denominated in the same currency.

Figure 21: Measures addressing liquidity risk

Interest and maturity matching requirements are in place. Interest rate matching covers a period of 12 months and takes into account payments to derivative counterparties. In addition, an assessment of maturity mismatches between covered bonds and cover assets, including derivatives, is reported to the central banks quarterly, as well as the weighted average interest rate by asset category and the weighted average interest rate of cover assets as a whole. Interest and maturity matching requirements are in place. Interest and maturity matching requirements are in place. Interest matching covers a period of 12 months and takes into account payments to derivative counterparties. Maturity matching requires that the remaining average maturity of the covered bonds does not exceed the remaining average maturity of the loans entered in the register. Interest matching requirement is in place and takes into account operational costs of the special purpose entity and payments to derivative counterparties. Interest, maturity and currency matching requirements are in place. Interest, maturity and currency matching requirements are in place. Interest matching covers a period of 12 months. Maturity matching requires a maturity for the cover asset pool that is not less than that of the mortgage/public covered securities related to the pool. The currency matching requires that the currency of assets in the pool is the same as the currency in which those securities are denominated. In addition, prudent market value of the pool should be greater than the total of the principal amounts of those securities. Cash flow matching requirement is in place. Cash flow matching requirement is in place institutions are required to draw up and submit to the central bank a liquidity map with the details of liquidity mismatches in accordance with at least the following deadlines: (i) up to 1 month; (Jurisdiction	Measures addressing liquidity risk
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		prudent and adequate. Additionally, whenever covered bonds and cover assets are denominated in



Jurisdiction	Measures addressing liquidity risk
	different currencies, the issuer must ensure the hedging of the currency risk. Furthermore, there are specific legal provisions in place to account for the major liquidity risks that could flow from possible maturity (and/or inflows/outflows) mismatches, such as: (i) the medium maturity of all outstanding bonds cannot surpass, in each moment, the medium maturity of all mortgage credits and cover assets; and (ii) the overall amount of interests to be paid with respect to the cover bonds cannot exceed, in each moment, the amount of interests to be received with respect to the cover assets.
Slovakia	Interest matching requirement is in place.
Spain	Cash flow matching requirement is in place. Issuers are required to adopt the necessary measures to avoid inappropriate imbalances between the flows from the cover assets and those derived from the payments to CH holders. There is also a mandate by law for the insolvency practitioner to sell substitution assets or source additional financing to mitigate potential temporary shortfalls and to ensure timely payments on CH obligations. In addition, the volume of CH issued and outstanding cannot exceed 80% of the sum of the unpaid principal amounts corresponding to all the mortgage credits or loans included in the issuer's eligible portfolio. The issuer cannot issue CH beyond these percentages at any time. If the limit is surpassed due to increases in the redemption of the eligible assets or any other event, the issuer shall reestablish due balance by means of any of the following actions: cash deposit or deposit of government paper in the central bank; acquisition of CH in the relevant marketplace; execution of new mortgage loans or acquisition of mortgage participations, provided that they are eligible to cover CH; and redemption of CHs by the pertinent amount until balance has been reinstated (which, if necessary, can be executed through early redemption).
Sweden	Cash flow matching requirement is in place. The national legislation requires that the cash flow from cover pool assets, derivatives and bonds should be such that the institution, at all times, can fulfil its obligations towards the bondholder and derivative counterparties. The cash flows accruing from cover pool assets, derivatives and bonds should be separated from the issuer's other assets into a specific account. The specific account should also be set up such that it remains separate in the event of bankruptcy.
United Kingdom	Interest matching requirements is in place and covers a period of 12 months.

Non-alignment

In three jurisdictions, there are no such liquidity buffer provisions in place. These include Austria, the Czech Republic and Luxembourg.



Best practice 6 - C: Stress testing

Best practice 6 – C: Stress testing

The legal/regulatory covered bond framework should require covered bond issuers to carry out stress test exercises on the calculation of the coverage requirement taking into account, at the very least, the following factors:

- Shifts in relevant interest rate curves based on historical performance, where data is available;
- Shifts in the currency pairs relevant to the covered bond programme based on historical performance, where data is available;
- Stresses on the credit quality of the underlying assets based on historical performance, where data is available;
- Stresses on the repayment behaviour of the underlying assets based on historical performance, where data is available;
- Stresses on the liquidation price of the underlying assets based on historical performance, where data is available.

The stress tests should also take into account other risks, including—but not limited to—set-off risks and commingling risks.

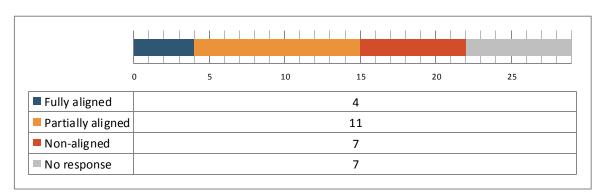


Figure 22: Member States' alignment to best practice 6 - C

In its 2014 EBA report, the EBA identified (as a best practice) the periodic implementation of stress test exercises on the main risks surrounding the covered bond programme, and the assessment of their implications on coverage and on the capability of the covered bond programme to achieve full and timely payment of its implications.

Content of stress testing

Full alignment

There is a low level of alignment with this best practice. The EBA found four jurisdictions to require covered bond issuers to conduct comprehensive stress tests (these being France, the Netherlands, Romania and the United Kingdom).



- In France, all SCF and SFH conduct stress tests on a quarterly basis in order to assess compliance with coverage requirements and to check whether a new production of loans by a mother bank would be necessary. The stress tests are self-assessed as considering factors covered in the EBA's best practice;
- In the Netherlands, the framework requires the issuers to conduct the stress tests on a regular basis in relation to a comprehensive set of risks (such as credit risk, interest rate risk, currency risk, liquidity risk and other risks that the central bank considers relevant). The tests take account of risk mitigating factors, such as derivative contracts. The objective is to check if banks are able to maintain the minimum coverage requirements in an adverse scenario as well as whether there is a healthy ratio between the total amount of outstanding covered bonds compared to the bank's total consolidated balance sheet. As such, the stress tests assess not only implications on the coverage requirements, but also on the entire balance sheet;
- In Romania, the framework requires issuers to ensure that the net present value coverage requirement is fulfilled, including under stress scenarios. For this purpose, the issuer needs to undertake stress tests on the coverage at least on a monthly basis by taking into account (at the very least) the following factors: interest rate risk, currency risk, stresses on the credit quality and repayment behaviour of the cover assets, and stresses on real estate market prices and on the values that could be collected by foreclosure procedures;
- In the United Kingdom, the issuers are required to conduct stress testing in view of ensuring full coverage of the claims attached to the bonds, timely payment of the claims, and sufficient quality of the assets in the cover pool. The stress tests are conducted on a monthly basis (or more frequently, depending on issuances schedule). The sourcebook indicates what factors the competent authority takes into account when assessing compliance with the regulation (these factors include credit, concentration, market and counterparty risks), as well as the interdependency between these factors. The sourcebook also sets out the issuer's mandate to set in place appropriate risk management, including carrying out stress testing. In addition, the competent authority conducts its own stress testing on a quarterly basis to monitor overcollateralisation levels in the cover pools.

Partial alignment

Besides the above four Member States, 11 other jurisdictions also require the issuers to carry out stress tests (Belgium, Cyprus, Denmark, Finland, Germany, Greece, Ireland, Norway, Poland, Sweden and Slovenia). In these instances, however, the types of stress tests do not fully align with the stress tests identified in the EBA's best practice. It may be the case that many, but not all, of the identified risk factors are considered in the stress tests, while it may also be the case that the framework requires issuers to conduct stress tests on other factors that are not covered by the best practice. In general, it can be concluded that there exists much heterogeneity on stress testing requirements in terms of the risk factors considered, frequency of the tests, terms of publication of the results, and the general objective of stress testing (i.e. whether the results are



for the informative purposes of the issuer or need to be reflected in the conduct of the covered bond business).

Figure 23: Further information on the stress tests conducted by covered bond issuers

Jurisdic tion	Further information on the stress tests conducted by covered bond issuers	Frequency of the stress tests
Belgium	The cover asset tests and the liquidity test must be met also in the case of sudden and unexpected movements in interest rates and exchange rates (internal stress tests or the option to simulate an immediate increase or decrease of interest rates by 2% and of exchange rates by 8%).	Continuous requirement
Cyprus	Stress testing is on interest rate changes, exchange rate changes, liquidity estimate, and the set-off reserve to be maintained at all times. Reporting is to the central bank and is on quarterly basis.	Monthly
Denmark	There is a requirement for the issuer to conduct stress test exercises on credit risk and on the calculation of the coverage requirement on a regular basis. In terms of the assessment of what is included in such a stress test, it is up to the issuer to decide what factors will be included this test. In determining this, the issuer shall consider improbable, but not entirely inconceivable, circumstances. The issuer may also consider special circumstances, particularly including the current position in the economic cycle. Matters such as new legislation that affect business and the competitiveness of the undertaking may also be included in these considerations. The reporting to the competent authority is on a yearly basis.	Regularly
Finland	The issuer should perform stress tests, according to the supervisory guidelines, where the market prices of the collaterals in the cover pool are stressed by decreasing market values.	In case of decreasing market values
Germany	The framework requires stress testing of (market) interest rate risk (the currency-specific yield curve for interest rates waps) and foreign exchange risk. Both risk types may be separately assessed in a static scenario or dynamic scenario. Alternatively, issuers who are permitted to use a regulatory market risk model for general interest rate risk may determine a risk amount to be subtracted from the cover pool's present value, where this risk amount is determined according to the parameterisation required for an interest rate dynamic scenario. Exchange rate risk has to be taken into account at least equivalently to the exchange rate dynamic scenario. Stress testing prepayment risk is not relevant as, in Germany, (bank) creditors are entitled to indemnification upon prepayment. Stress testing of the liquidation price of underlying assets is not relevant due to the long-term nature of the outcomes for mortgage lending valuation.	Weekly
Greece	The net present value require ment should apply if a hypothetical movement in interest rates is made.	Quarterly
Ireland	Requirements regarding interest rate risk have been imposed on all DCIs such that the net present value on the balance sheet of an issuer arising from a predetermined upward shift, downward shift and twist in the yield curve must not exceed 10% of the DCI's total own funds at any time.	Continuous requirement
Poland	The fra mework requires the issuers to carry out stress test exercises at least every 6 months on the calculation of coverage requirement, taking into account the exchange risk. There is also a liquidity test requirement that, in fact, is a stress test, conducted for 6- and 12-month time horizons, and which a nalyses interest rate and exchange rate factors. The frequency is no less then every 3 months.	Semi-annually, quarterly
Slovenia	Covered bond issuers are required to carry out stress test exercises on the calculation of the coverage requirement according to the regulation on the matching of cover assets and issued mortgage bonds and municipal bonds. Factors taken into account are shifts of the interest rate yield curves based on historical performance, and shifts of the currency pairs based on historical performance.	Monthly
Sweden	The issuers are required by regulation to at least annually perform stress tests on the cover pool in order to see its implications on the matching requirements (matching of the cover pool to the value of claims against an issuing institution due to covered bonds). Market values, interest rate risks and currency risks are considered in such stress tests.	Continuous requirement (interest rate risk and currency risk), annually
Norway	An issuer conducts periodic stress tests to document a satisfactory liquidity reserve and the value of the cover pool.	Regularly



Non-alignment

Seven jurisdictions have not set out a requirement for covered bond issuers to conduct specific covered bond stress tests on their covered bond programmes. These jurisdictions include: Austria, the Czech Republic, Italy, Luxembourg, Portugal, Slovakia and Spain. Issuers in these jurisdictions may, however, carry out voluntary stress tests exercises in order to monitor the coverage requirement and are, at the same time, subject to general supervisory monitoring that entails stress test exercises by the issuer in general.

Furthermore, with regard to Spain, the covered bond framework does not require a stress test exercise on the calculation of the coverage requirement as such, especially given the high level of regulatory overcollateralisation (the highest in the EU, at the level of 25%).

Frequency of stress testing

The EBA's best practice recommendation did not recommend a specific frequency for stress tests apart from recommending they should be conducted on a regular basis. The EBA observes the following practices with regard to frequency.

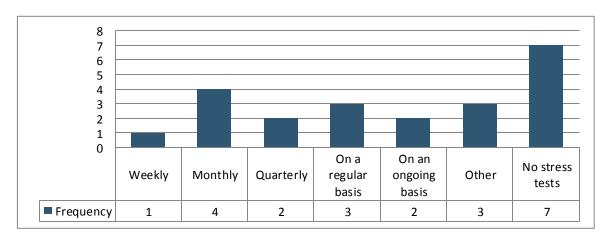


Figure 24: Practices observed for stress testing frequency

As displayed in the above figure, one jurisdiction requires stress tests to be conducted on a weekly basis (Germany), four jurisdictions on a monthly basis (Cyprus, Romania, Slovenia and the United Kingdom), two jurisdictions on a quarterly basis (France and Greece), three jurisdictions on a regular basis (Denmark, the Netherlands and Norway), and two jurisdictions as part of an ongoing requirement (Belgium and Ireland). Sweden requires continuous compliance with stressed requirements on interest rate risk and currency risk, defined as daily calculations, whereas stress test on market values is required on an annual basis. Poland conducts stress tests on the coverage requirement semi-annually, and the liquidity tests on a quarterly basis. Finally, in case of Finland stress tests are conducted in the case of a decrease in market prices of collaterals.



Best practice 7 – A: Appointment of the cover pool monitor

Best practice 7 – A: Appointment of the cover pool monitor

The legal/regulatory covered bond framework should provide that, at the establishment of a given covered bond programme, a cover pool monitor is appointed. The framework should: i) ensure that the cover pool monitor is an internal or external entity other than the ordinary auditor of the covered bond issuer; and ii) provide an eligibility criteria for the appointment of and the cover pool monitor's main duties and powers including, but not limited to, the monitoring of all coverage requirements and eligibility tests and random auditing of the cover pool.

Where similar tasks are directly carried out by the competent authority, the appointment of a cover pool monitor may not be necessary.

The cover pool monitor and/or the issuer, based on the findings of the cover pool monitor, should regularly report to the competent authority.

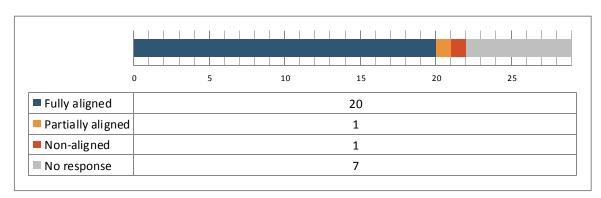


Figure 25: Member States' alignment with best practice 7 - A

Full alignment

There is a very high level of alignment with the best practice on the cover pool monitor. In all but two jurisdictions, the national frameworks establish the position of a cover pool monitor separate from the position of an ordinary auditor of the issuer, and usually with a decisive role of the competent authority in the appointment and/or dismissal of the cover pool monitor. In a substantial majority of jurisdictions, the tasks are executed by an entity separate from the competent authority; in such cases, the frameworks prescribe the criteria on the eligibility, experience and independence of the cover pool monitor. In three jurisdictions (Denmark, Finland and Spain), the tasks of cover pool monitoring are executed by the competent authority in the context of the general supervision of the issuer.

The frameworks in all the jurisdictions set out the duties and powers of the cover pool monitor. There does not seem to be substantial variances in this regard between individual frameworks. The main duties observed include the following: monitoring compliance of the cover pool with the regulatory requirements, including coverage, liquidity, eligibility, overcollateralisation and transparency requirements; checking coverage and liquidity calculations; verifying the correctness



of the valuation of mortgages in the cover pool; performing random audits of the assets in the cover pool; ensuring correct registration in the cover registers; approving removal/replacement/addition of the assets in the cover pool; and using the proceeds of realised cover assets.

The national legislations also prescribe notification and reporting duties for the cover pool monitor in terms of the competent authority. The frequency of regular reporting is at least on an annual basis, but usually also more often, such as semi-annually, quarterly or even monthly. Additional reporting requirements may be set out for specific circumstances, such as in the case of issuances above certain thresholds, and the addition/removal of the cover assets in the cover pool.

Observed powers of the cover pool monitor include the right to access information/documentation, and the right to require the issuer to answer any relevant questions necessary for the purposes of executing his duties.

Partial alignment

One jurisdiction (Norway) is considered as partially aligned, as its framework allows that the issuer's auditor may be appointed as the cover pool monitor. Otherwise, the framework seems aligned with other aspects of the best practice, as it sets out requirements for the cover pool monitor's appointment, duties and powers, as well as for reporting to the supervisory authority.

Non-alignment

Only in the Czech Republic is cover pool monitoring not required by the legislation. The issuer is, however, required to keep separate records on liabilities in covered bonds, on coverage and on the valuation of assets in the 'coverage register' and in the 'coverage ledger'. The content of the records is defined in the regulation.



Best practice 7 – B: Supervision of the covered bond issuer

Best practice 7 – B: Supervision of the covered bond issuer

The legal/regulatory covered bond framework should provide that the competent authority approves the establishment of a covered bond programme by a given issuer. A covered bond programme shall be considered as established when a cover pool is established for the inaugural covered bond issue. Within the same covered bond programme, additional collateral may be subsequently added to the cover pool and further covered bonds may be issued granting investors claims that rank pari passu with claims attached to the existing bonds collateralised by the same cover pool in the event of the issuer's insolvency.

At the establishment stage, the competent authority should be satisfied, at least on the basis of information received from the issuer, that: i) adequate operational policies, procedures and controls are put in place by the issuer for the management of the covered bond programme, including in the case of the issuer's insolvency or resolution scenario; ii) the restrictions applicable to the issuer are met (where provided by the national framework); and iii) the features of the cover pool meet the applicable requirements.

The EBA acknowledges that the supervisory practice of licensing specialised covered bond issuers—which only carry out covered bonds issuance activity and related ancillary activities—may ensure a level of supervision of the issuer that is comparable to the one achieved by the authorisation of the establishment of a new covered bond programme. In any case, all the applicable requirements attached to the granting of a licence should be regularly monitored and the establishment of new covered bond programmes should, as a minimum, be subject to ex ante notifications to the national authority.

The legal/regulatory covered bond framework should provide a clear and sufficiently detailed illustration of the duties and powers of the competent authority regarding the ongoing supervision of applicable activities/regulatory requirements of covered bond issuers.

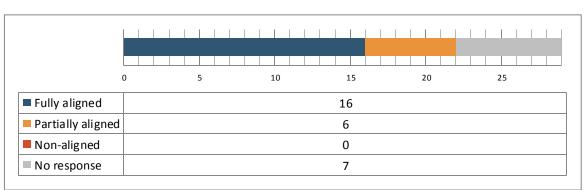


Figure 26: Member States' alignment with best practice 7 – B

A legal requirement of 'special public supervision for the protection of the bond investor' constitutes one of the core features of a covered bond, as also required in accordance with Article 52(4) of the UCITS Directive. Although there is no definition for the term, it can be



expected that these supervisory rules and practices should go beyond the ordinary supervision of credit institutions. Involvement of supervisory authorities can take place at several stages: the EBA's analysis focuses on supervision prior to issuance (i.e. relating to the approval of the covered bond business) and the ongoing supervision of the issuer (i.e. prior to insolvency).

Full alignment

Sixteen jurisdictions have been self-assessed as fully aligned with the EBA's best practice (Belgium, Germany, Denmark, Spain, Finland, France, Greece, Ireland, Luxembourg, the Netherlands, Poland, Portugal, Romania, Sweden, Slovenia and the United Kingdom). However, overall, the EBA's analysis confirms considerable heterogeneity in the level of detail and comprehensiveness of the rules in individual jurisdictions with regard to supervisory oversight of covered bond programmes, with some frameworks establishing core supervisory requirements with respect to covered bond programmes and other frameworks setting out a comprehensive and detailed set of rules and requirements for a wide range of aspects of supervision.

The regulatory frameworks in these jurisdictions have been self-assessed as generally requiring that the establishment of the covered bond programmes is approved or licensed by the competent authority or (as a minimum) is subject to prior notification. Approval/licensing is normally performed off-site based on documentation and evidence provided by the issuer, and can be accompanied by on-site inspections.

As part of the approval/licensing process, the competent authorities normally assess the adequacy of operational policies put in place by the issuer for the management of the covered bond programme. Various aspects are checked in different jurisdictions in the context of such assessment, including, inter alia, adequacy of risk management strategies, governance, IT and internal control systems, the issuer's organisational structure, and/or adequacy of these systems with respect to the complexity of the covered bond business.

Other aspects considered by different jurisdictions as part of the approval/licensing process include the compliance of the cover pool with applicable requirements and other relevant aspects as relevant such as impact of the covered bond programme on the issuer's liquidity situation, consistency with the issuer's long-term funding strategy, proper integration of the covered bond programme in banking activity, as well as financial forecasts for the following years.

The national frameworks in these jurisdictions also specify the duties and powers of the competent authorities in relation to ongoing supervision of covered bond programmes, with different level of complexity in different jurisdictions. Beyond duties/powers in relation to approval/licensing of the programmes (as per above), the observed duties and powers may cover various aspects such as supervision of changes in the features of the existing covered bond programmes, on-site and off-site inspections, a decisive role in the appointment/dismissal of cover pool monitors, supervision of asset eligibility to be included in the cover pool, supervision of asset valuation criteria, and supervision of coverage calculation. Furthermore, the national frameworks generally prescribe reporting requirements for the issuers, cover pool monitors and special administrators dealing with the administration of covered bond programmes post the



issuer's insolvency. The competences also include prompt corrective, enforcement and intervention powers in the case of non-compliance with applicable requirements. The scale of these actions varies, and includes actions from increased monitoring, establishing more intensive or frequent reporting requirements, imposing a time period for remedial action, imposing specific actions to be taken by the issuer, such as higher coverage requirements, imposing fines and pecuniary sanctions, appointing imposed special administration and revoking licence for the issuance of covered bonds.

Partial alignment

Six jurisdictions are considered as partially aligned (Austria, Cyprus, the Czech Republic, Italy, Norway and Slovakia). The frameworks in these jurisdictions are fully aligned with some of the individual sub-recommendations in the EBA's best practice; however, in some aspects, the framework deviates from the best practice. In the majority of cases, this is because the framework does not specifically require the approval of individual covered bond programmes.

- In Austria, the issuer is subject to general audits by the competent authority (e.g. on-site visits, off-site analysis). The national framework, however, does not set out specific duties and powers regarding the ongoing supervision of covered bond programmes, nor does it request individual approval of covered bond programmes;
- In Cyprus, the framework requires the approval of the covered bond programme, as well as
 attribution for a one-off specific licence for covered bonds. The framework also sets out the
 duties and powers of the competent authority with respect to covered bond programmes.
 There is no specific request for considering operational policies and procedures in the covered
 bond approval process;
- In the Czech Republic, the competent authority carries out general ongoing supervision and periodical on-site inspections within which it focuses on aspects relevant to covered bonds. There is no approval of individual covered bond programmes; a general approval of the establishment of covered bond programmes is encompassed in the authorisation for banking activities. In addition, the competent authority approves prospectus if the covered bond issuance is intended to be admitted for trading on a regulated market;
- In Norway, there is no approval of individual covered bond programmes; however, issuers are specialised institutions and are subject to licensing requirements. The issuers are subject to general supervisory rules. The framework sets out directions on assessing different kinds of risks in financial institutions but not directly in relation to covered bond issuers;
- In Italy, the framework does not provide for the approval (by the competent authority) of the establishment of each covered bond programme/issuance. However, the issuance of covered bonds is only allowed for banks that meet these two requirements (jointly): minimum own funds of EUR 250 million, and a total capital ratio of 9%. Compliance with these requirements is assessed under the ordinary supervisory activity. The supervision of regulatory requirements applicable to covered bond issuers is part of the ongoing supervision for all



entities, both off-site (based on regular reporting by the issuers) and on-site (in the context of general and special inspections). The supervisory methodologies are detailed in the supervisory guidelines. In particular, the guidelines specify the cases for which on-site indepth verifications have to be performed in terms of the process of structuring covered bonds, monitoring the quality of the cover pool, and ensuring compliance with the regulatory framework for covered bonds;

• In Slovakia, the framework does not provide for individual approval of covered bond programmes. However, only those institutions that are provided with a specific licence for the issuance of covered bonds (extending beyond the general banking licence) are allowed to issue these bonds. Furthermore, the prospectus of the covered bond issuance is subject to approval by the competent authority. The framework sets out a comprehensive set of duties and powers of the competent authority vis-à-vis the issuers of covered bonds in the context of general supervision and prudential supervision.

Non-alignment

No jurisdictions are considered as non-aligned with the EBA's best practice.



Best practice 7 – C: Duties and powers of the national authority in a scenario of the issuer's insolvency

Best practice 7 – C: Duties and powers of the national authority in a scenario of the issuer's insolvency

The legal/regulatory covered bond framework should provide a sufficiently detailed description of what the duties and powers of the competent authority are for the covered bond programme, as well as its administration, in a scenario of the issuer's insolvency.

0 5 10 15 20 25

Fully aligned 19
Partially aligned 3
Non-aligned 0
No response 7

Figure 27: Member States' alignment to best practice 7 - C

A satisfying degree of clarity should also be provided for the role of the competent authority in the case of the issuer's insolvency, given the intended bankruptcy-remote nature of covered bonds in terms of the issuer's insolvency and the investor's privileged recourse to cover pool assets in such a scenario.

Full alignment

Most jurisdictions (19 in total) appear to spell out the competent authorities' duties and powers in the event of the issuer's insolvency relating specifically to covered bonds, although the extent of such specific duties and powers varies from one jurisdiction to another. They include, inter alia: decisive role in approval/dismissal of the covered bond administrator, approval/consent/consultation on the series of actions taken by the administrator (e.g. transfer/selling of the cover pool (part or whole) to another bank or accessing new funding sources for covering liquidity deficits), and power to order special audits and to bestow additional powers on the administrator.

Partial alignment

Three jurisdictions (Austria, Norway and Slovakia) are considered partially aligned, as their frameworks describe duties and powers of the competent authority in the event of the issuer's insolvency, but these powers and duties are either not specified or are given in less detail with regard to covered bond programmes.



Non-alignment

No jurisdictions are considered non-aligned.



Best practice 8 - A: Scope of disclosure

Best practice 8 – A: Scope of disclosure

The legal/regulatory covered bond framework should require covered bond issuers to disclose aggregate data on the credit risk, market risk and liquidity risk characteristics of cover assets and covered bonds of a given programme, as well as other relevant information, including information concerning counterparties involved in the programme and levels of contractual and voluntary overcollateralisation. The information should be disclosed to a level of detail that enables investors to carry out a comprehensive risk analysis.

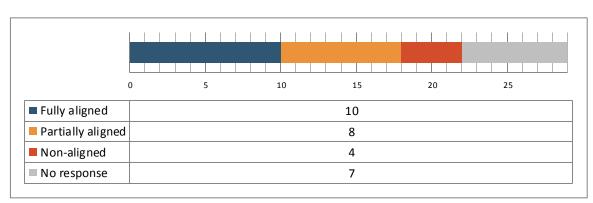


Figure 28: Member States' alignment with best practice 8 - A

Artide 129 of the CRR sets out disclosure requirements for the issuer, so that the investors of covered bonds (credit institutions and investment firms) can be eligible for preferential risk weight treatment on their covered bond investment. Having taken account of national practices, market initiatives in the area of disclosure (particularly the ECBC's HTT and the International Capital Market Association's (ICMA's) transparency template) and the general approach to covered bond disclosures by major credit rating agencies, the EBA has identified a number of areas of information that should be made available to investors for risk analysis and which should be mandatory for covered bond issuers to disclose in the legal/regulatory covered bond frameworks. The disclosure requirements recommended in the EBA's best practice extend beyond the disclosure requirements specified in Article 129 of the CRR and are meant to be applicable to all covered bonds (i.e. not only to those that seek preferential risk weight treatment).

It has been observed that many covered bond issuers disclose comprehensive information on their covered bond programmes to a degree closer to, or exceeding, the identified best practices, while this may not necessarily be required by national frameworks. This would appear to demonstrate the capability of issuers to go further than the current legislative requirements. For the purposes of assessment of alignment with the best practice, however, voluntary disclosure requirements that are not anchored in the legal/regulatory frameworks have been considered in the assessment of alignment with the EBA's best practice.



It should be noted that the issuers in the following jurisdictions have adopted national transparency templates (NTTs) in the context of the ECBC's NTT initiative: Austria, Denmark, Finland, France, Germany, Ireland, Italy, the Netherlands, Norway, Portugal, Spain, Sweden and the United Kingdom. The issuers in the following jurisdictions have adopted the HTT: Denmark, Finland, France, Germany, Ireland, Italy, Norway, Portugal, Spain, Sweden and the United Kingdom, and more countries are in the pipeline.

Full alignment

In 10 jurisdictions, a fully comprehensive disdosure requirement is laid out in the legal/regulatory frameworks (Cyprus, Denmark, Finland, France, Germany, Greece, the Netherlands, Portugal, Spain and the United Kingdom). The regulatory disclosure requirements cover detailed information in the areas of the identified best practices, and often set further disdosure requirements beyond the best practice.

Various practices have been observed in various jurisdictions, such as the information is required not only in nominal value, but also in present and stressed present value of cover assets and covered bonds. The disclosure requirements in some cases follow the ECBC's and ICMA's templates and/or are supported by the disclosure templates developed by authorities. The disclosure of the cover register or summary of the cover register is required. The disclosure is normally required on an aggregated basis (with the exception of one jurisdiction—the United Kingdom—which requires disclosure on loan-by-loan level). Some jurisdictions also disclose information not only on the risk characteristics of the cover assets and covered bonds, but also on the other characteristics related to the dual recourse of the product, such as the legal nature of the cover pool, the segregation of cover assets, and the insolvency remoteness of covered bonds. The information is disclosed via different ways, such as in prospectuses, issuers' annual and interim reports and financial statements, issuers' we bsites, or through registers maintained and published by authorities.

Partial alignment

There are a number of jurisdictions that do require disclosure of covered bond programmes, albeit not necessarily on all factors identified as best practice (the Czech Republic, Ireland, Italy, Luxembourg, Norway, Poland, Romania and Slovakia).

Non-alignment

Where jurisdictions have not adopted this identified best practice, this is typically due to the absence of specific disclosure requirements with respect to covered bonds. In some cases, and without prejudice to mandatory disclosures in terms of securities admitted to negotiation in regulated markets, the issuers disclose information on a voluntary basis—e.g. in the context of Pillar 3 reports, annual reports, voluntary disclosure templates (adopting, for example, the HTT),

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⁸ Singapore has also a dopted the NTT.



or in voluntary registers kept and maintained by market associations. Jurisdictions where this is the case include: Austria, Belgium, Slovenia and Sweden.

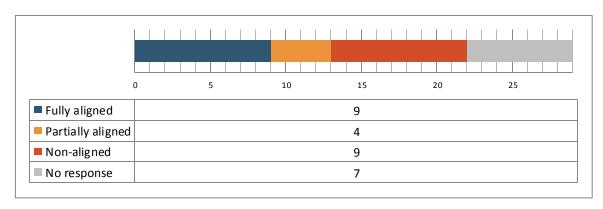


Best practice 8 – B: Frequency of disclosure

Best practice 8 – B: Frequency of disclosure

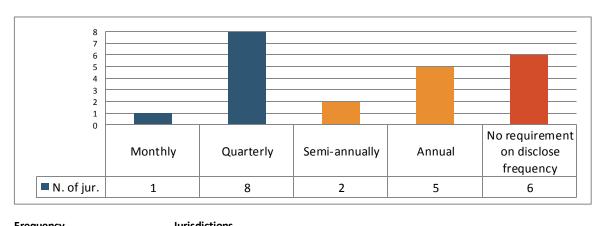
The legal/regulatory covered bond framework should provide that the disclosure of the information mentioned under the best practice 8 – A should occur at least on a quarterly basis.

Figure 29: Member States' alignment with best practice 8 - B



In addition to the disclosure requirement, the timeliness of such disclosure is also important in ensuring the quality of information that investors receive in order to be able to conduct comprehensive risk analyses. The EBA recommended the disclosure at least on a quarterly basis; it should be noted that Article 129 of the CRR requires disclosure on semi-annual basis for the purposes of preferential risk weights (i.e. this requirement is not applicable to all covered bonds).

Figure 30: Frequency of the disclosure requirement



Frequency	Jurisdictions
Monthly/quarterly	United Kingdom
Quarterly	Cyprus, Germany, Denmark, Finland, France, Greece, the Netherlands, Romania
Semi-annually	Italy, Portugal
Annually	Czech Republic, Ireland, Norway, Slovakia, Spain
No requirement with regard	Austria Dalaina Lunarahanna Dalard Clausia Consdan
to disclosure frequency	Austria, Belgium, Luxembourg, Poland, Slovenia, Sweden



Full alignment

Nine jurisdictions are considered fully aligned, as they require disclosure on a quarterly basis (Cyprus, Germany, Denmark, Finland, France, Greece, the Netherlands and Romania). In the United Kingdom, information disclosure is required for the asset and liability sides on a monthly or quarterly basis. In addition, issuers are required to publish loan-level data on a quarterly basis.

Partial alignment

Four jurisdictions are assessed as partially aligned (Italy, Norway, Poland and Portugal). In Italy and Portugal, the frequency of disclosure is in line with Article 129 of the CRR—i.e. on a semi-annual basis. In Poland, the disclosure also takes place as specified in the CRR; however, it is on a voluntary basis. With regard to the framework in Norway, covered bond issuers are required to disclose information at least on a quarterly basis. However, information on credit, market and liquidity risks is required to be disclosed on an annual rather than quarterly basis.

Non-alignment

Nine jurisdictions are considered non-aligned, as they either require disclosure annually (the Czech Republic, Ireland, Slovakia and Spain) or—without prejudice to mandatory disclosures in terms of securities admitted to negotiations in regulated markets—there is no express requirement regarding the frequency of disclosure with respect to covered bonds (Austria, Belgium, Luxembourg, Slovenia and Sweden).



Chapter 2: Analysis of the latest market trends and EU regulatory developments

2.1 Summary of the analysis of the latest market trends and EU regulatory developments in relation to covered bonds

This section summarises the latest market trends and regulatory developments in relation to covered bonds since the publication of the 2014 EBA report.

Overall, the observed market and regulatory developments confirm the traditional positive approach of both regulators and market participants towards the covered bond model. Whereas covered bonds are becoming more and more attractive in countries outside the EU, they remain the key funding instrument of the EU economy and have confirmed their position as a reasonably resilient source of financing also in times of market stress. The EBA's analysis particularly focuses on the following key market and regulatory trends observed in the past 2 years (with a reference date as of end 2015):

- Dynamics in issuance and outstanding volume of covered bonds, showing increasing issuance of covered bonds both in the EU and worldwide;
- Expansion of the covered bond market outside the EU, including first issuances by Asian countries in 2015, confirming the trend of globalisation for the covered bond market;
- Changes in the composition of the covered bond investor base, with (i) asset managers, insurance and pension funds showing a tendency to exit the market (their share decreased from 50% in 2009 to 32% in 2015); (ii) central banks substantially expanding their share as a consequence of the Eurosystem's CBPP3 (their share was 31% of the total investor base as of end 2015; it doubled in a period of 1 year and is now almost four times larger than in 2009); and (iii) banks maintaining their position as the largest covered bond investors (with 35% of investor base in 2015), reflecting favourable regulatory treatment in the EU;
- Continuation of a trend observed in the last decade of an increasing use of mortgages as cover
 pool collateral (representing 83% of the cover pools of outstanding worldwide covered bonds
 in 2014, compared to 46% in 2005), conversely coinciding with the declining volume of public
 sector loans and other asset classes in cover pools;
- Treatment of covered bonds under the euro area monetary policy and the Eurosystem's CBPP3, which represents the most important factor of the covered bond primary supply;
- Treatment of covered bonds under the EU LCR framework, which allows the inclusion of covered bonds in the liquidity buffer under favourable conditions going beyond stricter



international and Basel standards and which (along with the CBPP3) represents another key driver of the covered bond market in the EU;

- Special treatment of covered bonds under the EU banking recovery and resolution framework, which exempts covered bonds from the scope of the bail-in instrument;
- Privileged treatment of covered bonds under the EU large exposure rules, according to which the covered bonds may be fully or partially exempted from the large exposure requirement;
- Favourable treatment under Solvency II, which grants low-spread risk factors to covered bond—i.e. preferential treatment under the spread risk module and concentration risk module;
- Developments in relation to rating agencies, mainly (i) changes in their rating methodologies, particularly due to the exemption of covered bonds from the bail-in tool and improvement in sovereign ratings and related country ceilings of covered bond ratings in peripheral Europe (which is reflected in upgrades of covered bond ratings and, in turn, in extensions of the eligibility of covered bonds under the LCR); and (ii) increased competition in the market for ratings for covered bonds;
- Innovation and changes in covered bond structures, which have led to a move from traditional hard bullet covered bond structures (whose maturity cannot be extended) towards an increased use of soft bullet and CPT formats of covered bonds, allowing the extension of the maturity usually to 1 year (for soft bullets) or to more than 30 years (for CPTs). While these structures allow to mitigate the liquidity and maturity mismatch risk of traditional hard bullet covered bonds, they pass the refinancing risks to the investors, involve a high level of complexities including long and uncertain theoretical maturities, and essentially introduce changes to the core characteristics of the covered bond product;
- Increase in transparency in the covered bond market through several market initiatives, particularly the development of the HTT by the ECBC.⁹

Following the summary of the main market and regulatory developments in the past 2 years, the last section provides an overview of recently finalised, ongoing and upcoming regulatory initiatives that are expected to have implications for covered bonds in the near future. They include the European Supervisory Authorities' (ESAs') RTS on risk mitigation techniques for OTC derivative contracts not cleared by a CCP, ESAs' ITS on mapping of ECAls' credit assessments, and the Commission's public consultation on covered bonds. They also refer to the EBA recommendations on a holistic review of the regulatory framework, which also has direct relevance for covered bonds. In addition, discussions are ongoing at an international level (in the Basel) that will also have implications on covered bonds, such as on the revision of the

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⁹ The HTT is operational since January 2016 and is a binding requirement for the granting and renewal of a Covered Bond Label.



standardised approach as well as a strategic review of the internal models (including the potential introduction of a capital floor for the internal models).

The EBA's analysis suggests that regulatory and market developments are particularly intertwined in the case of covered bonds. As such, new EU prudential requirements in place (particularly in the area of liquidity and resolution) and continued extraordinary monetary policy measures in the euro area have considerably affected the dynamics of the covered bond markets, primary and secondary trade volumes, spreads, investor base composition and rating assessments by credit rating agencies.

The most recent market developments highlight the importance of considerations—by regulators and market participants alike—as to whether further EU harmonisation and legislative underpinning of covered bonds is warranted in order to justify a preferential prudential and risk weight treatment of covered bonds in the EU in the mid/long term. High levels of diversity existing in legal, regulatory and supervisory frameworks across EU jurisdictions underline the argument for a need for further harmonisation. When considering the case of further harmonisation, particular attention should be paid to the following observations (based on the EBA's analysis):

- The existing EU bank prudential regulation remains extremely friendly towards covered bonds and this is reflected in the fact that banks represent the largest covered bond investor class in terms of market share. In particular, LCR eligibility is considered the key covered bond market driver and a crucial factor for banks' investments in covered bonds;
- Covered bonds are important for the transmission channel of the euro area monetary policy.
 The Eurosystem's CPPP3 remains, along with the LCR, the key driver with substantial impact
 on the covered bond market, attracting new and returning issuers to the market. No clarity
 exists on the consequences of an eventual unwinding of the CBPP3 for the functioning of the
 market for covered bonds in Europe;
- Covered bonds benefit from favourable rating assessments and have recently been subject to upgrades, which have, in turn, extended the eligibility of covered bonds across the EU under the LCR;
- Use of innovative covered bond structures such as the soft bullets and CPT formats has expanded considerably while not being subject to specific harmonised EU regulatory treatment that would reflect complexities involved in such structures, which gives rise to prudential and regulatory concerns.



2.2 Overview of main trends and developments in the covered bond market

Dynamics in covered bond supply – Outstanding volume, issuance and composition of cover pools

According to the ECBC data, the covered bond market has experienced smooth development over recent years, with an average growth rate of 7.5% since 2007. Following the financial crisis, the market contracted by 8% for the first time. This trend has attenuated in 2014, as the tightening of the market slowed down to 4%. In 2015, the contraction came to a standstill, with the outstanding volume of covered bonds reaching EUR 2.5 trillion, which represents a decrease of 0.25% on a year-to-year basis. As of 2015, there were 314 active covered bond issuers and 434 covered bond programmes in 30 countries both in and outside the EU. Germany remains the largest market in terms of outstanding volume (EUR 384 billion), followed by Denmark (EUR 383 billion), France (EUR 323 billion), Spain (EUR 281 billion), Sweden (EUR 222 billion), Italy (EUR 131 billion) and the United Kingdom (EUR 121 billion).

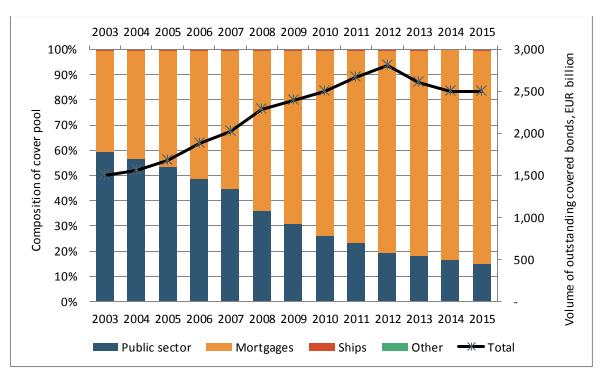


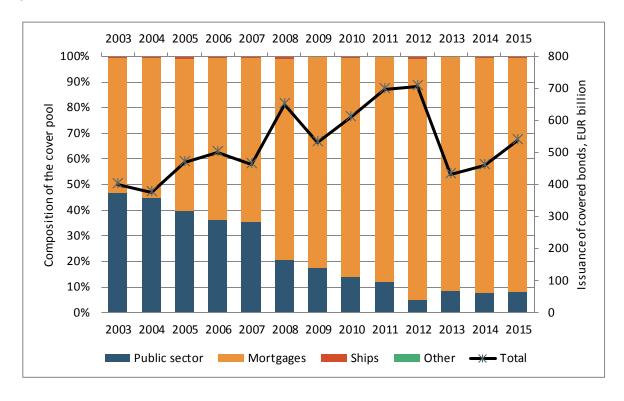
Figure 31: Volume of outstanding covered bonds (EUR billion)

SOURCE: EBA CALCULATIONS, THE ECBC

With regard to issuance, an increasing trend can be observed since 2013, with EUR 540 billion issued in 2015. Denmark is by far the country with the largest new issuance volumes (EUR 164 billion). Other major issuers are Sweden (EUR 61 billion), Germany (EUR 58 billion), France (EUR 45 billion), Spain (EUR 42 billion) and Italy (EUR 29 billion).







SOURCE: EBA CALCULATIONS, THE ECBC

According to market research (Deutsche Bank, Bank of America Merrill Lynch (BAML), Bloomberg, the ECBC), the Eurosystem's CBPP3 has been a key driver of the most recent primary supply and has spurred expansion of the covered bond issuer base. The supply was also supported by market volatility caused by various idiosyncratic or systemic risks, such as the Greek bail-out and resolution of Austria's Heta, indicating that covered bonds may act as a safer funding alternative in times of stress as the senior unsecured market may be closed or too expensive. Macroeconomic conditions were also favourable for the supply of covered bonds, as these instruments have helped protect net interest income in a low yield environment, especially in peripheral jurisdictions.

As illustrated in the 2014 EBA report, covered bonds have been traditionally funding exposures to public sector entities and to real estate finance due to a combination of historical and regulatory factors. The recent 2015 ECBC data confirms the continuation of a trend in the last decade towards the increase in the share of mortgage and other real estate loans in cover pools (representing 84% of cover pools of outstanding worldwide covered bonds in 2015, compared to 40% in 2003), conversely coinciding with declining volumes of public sector loans and other smaller asset classes such as aircraft, ship and SME loans. The trend has been spurred by the global financial crisis, which has had a much more severe impact on the price and availability of other alternative funding sources for funding mortgage loans, such as RMBSs.



Expansion of covered bonds outside the EU – Covered bonds becoming a global product

Albeit a fully European instrument by tradition, covered bonds have increasingly expanded in recent years to being a global product, with the increasing importance of non-EU jurisdictions from both supply and investor perspectives and Asian countries among the latest newcomers (the first Asian covered bonds were issued in 2015).

Covered bond markets currently exist in around 40 jurisdictions across the globe. Besides active markets in almost all EU countries, a number of jurisdictions outside Europe have (in the past years) implemented covered bond legislations: Australia, Canada, New Zealand, Singapore, South Korea, Turkey and Russia. Other major jurisdictions—including Brazil, Chile, India, Japan, Mexico, Morocco, Panama, Peru, South Africa and the United States—are either in the process of adopting covered bond legislation or are investigating the introduction of covered bonds.

Changes in the composition of the investor base

The investor base has been subject to notable changes in the last 2 years, particularly driven by two major factors: the Eurosystem's CBPP3 and the latest regulatory developments, including the entry into force of the LCR Delegated Act.

As a consequence of CBPP3, the share of central banks in the primary market almost doubled in a period of 1 year (from 16.6% in 2014 to 30.9% in 2015). Compared to 2009 (8.9%), the share is almost four times larger. In relation to this, the extent of home bias has increased, as the central banks tend to primarily buy domestically. Asset managers, insurance companies and pension funds have shown a tendency towards exiting the market: their share in the investor base declined from 50.6% in 2009 to 31.9% in 2015, potentially due to reducing their covered bond holdings in favour of other asset dasses with more tightening potential and higher yielding alternatives.

With regard to banks, their share in the investor base decreased to 34.8% in 2015 from 40.4% in 2014, although they remain the largest covered bond buyers. Market participants confirm that banks' demand for covered bonds has been significantly spurred due to the LCR regulatory developments and considerations of LCR eligibility. The market share of hedge funds, agencies, retail investors and corporates in the investor base has remained marginal.



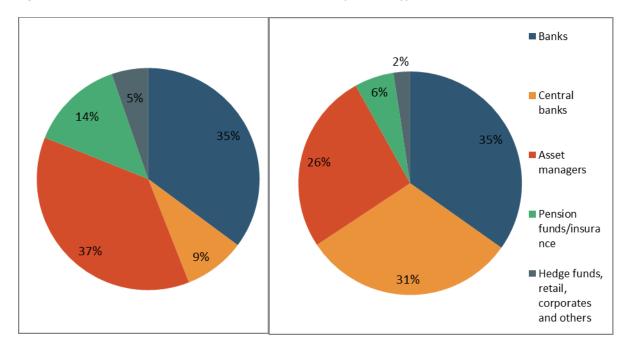


Figure 33: Allocation of euro benchmark covered bond issuance by investor type (in 2009 and 2015)

SOURCE: EBA CALCULATIONS, BAML

The Eurosystem's CBPP3

Covered bonds are one of the main pillars of the Eurosystem's quantitative easing policy. The most recent Eurosystem's CBPP3¹⁰ started in October 2014 and will continue until at least March 2017. The purchases under CBPP3 are conducted in both primary and secondary markets (the share of primary market purchases was at 29.31% as of end October 2016). Compared to the CBPP1 and CBPP2, the CBPP3 does not apply any minimum size or any specific maturity for the covered bond purchased. CBPP3 requires covered bonds to have at least one rating not lower than BBB- (or be rated at the currency ceiling in the case of Greek or Cypriot covered bonds, subject to additional risk mitigants). All euro benchmark covered bonds issued by euro area banks and compliant with the CBPP3 eligibility criteria qualify for CBPP3. Moreover, the Eurosystem can also purchase EUR-denominated non-benchmark covered bonds issued by euro area banks, and, unlike CBPP1 and CBPP2, also retained covered bonds. The Eurosystem holdings under the CBPP3 as at mid November 2016 amounted to EUR 200.43 billion. The Eurosystem thus currently owns almost one third of the total euro benchmarks issued by euro area issuers, while the European Central Bank's (ECB's) holdings of asset-backed securities purchases under ECB's asset-backed

Decisions of the ECB of 15 October 2014 on the implementation of the CBPP3: https://www.ecb.europa.eu/ecb/legal/pdf/oj-jol_2014_335_r_0010-en-txt.pdf?628b5a15ca115d52642685f6d24ccf2d. Technical details of the Eurosystem's CBPP3:

 $[\]frac{\text{https://www.ecb.europa.eu/press/pr/date/2014/html/pr141002} \ 1 \ \text{Annex} \ 2.pdf?0ba2a520b8a2b7ad8ff6bfb99333ba2}{5}.$



securities purchase programme (ABSPP) are significantly smaller (EUR 21.951 billion as of mid November 2016). 11

100% 250 80% 200 60% 150 100 40% 20% 50 0% Jul-16 Jul-15 Sep-15 Oct-15 Dec-15 Jan-16 Jun-16 Jun-15 Aug-15 Nov-15 ■ Primary market Secondary market → Total holdings

Figure 34: Total holdings of the Eurosystem under the CBPP3 (at amortised cost, EUR billion)

SOURCE: ECB

Figure 35: Comparison of the basic characteristics of CBPP1, CBPP2 and CBPP3

	CBPP 1	CBPP 2	CBPP 3
Start date	7/10/2009	11/14/2011	10/20/14
End date	6/30/2010	10/31/2012	03/2017
Duration	12 months	12 months	At least 24 months
Total size	EUR 60 billion	EUR 40 billion	No target size
Where will the Eurosystem buy?	Primary, secondary	Primary, secondary	Primary, secondary and retained
Allocation	ECB retained EUR 4.8 billion, the rest was distributed based on ECB's capital share	Across the euro area	Carried out progressively by the ECB and the Eurosystem national central banks
Location of issuer scope	euro area	euro area	euro area
Currency	EUR	EUR	EUR
Maturities	3-10 years, with strong focus on maturities up to 7 years	Up to 10.5 years residual maturity	No limitations
Minimum rating	At least one AA rating and no rating below BBB-	BBB- (best rating counts)	BBB- (best rating counts)
Minimum volume (EUR million), in any case not below 100	As a rule, 500	300	No minimum volume
Maximum purchase percentage per bond	No explicit limit	No explicit limit	70% as per ISIN (30% in case of Greek and Cypriot covered bonds)
Regulatory minimum requirement	UCITS or equivalents afeguard (similar to own-use covered bond rules)	UCITS or equivalent safeguard (similar to own-use covered bond rules)	ECB repo eligible and fulfilling the conditions for acceptance as own-use collateral; multi- cedulas

SOURCE: THE ECBC, DEUTSCHE BANK

The Eurosystem's expanded asset purchase programme (APP) consists of CBPP3, ABSPP, public sector purchase programme (PSPP) and corporate sector purchase programme (CSPP): https://www.ecb.europa.eu/mopo/implement/omt/html/index.en.html.



Treatment of covered bonds under the LCR Delegated Act

According to market participants, the entry into force of the Commission's Delegated Act on LCR (LCR Delegated Act)¹² was a major factor influencing covered bond markets in the past 2 years. The effect on the demand is described to be significant. While, in the past, investment decisions mostly factored in determinants such as market volatility, liquidity and market pricing, today, market participants look at LCR eligibility as a key criterion.

The LCR Delegated Act—which entered into force on 1 October 2015 and will be fully implemented at the beginning of 2018 and which represents EU-wide implementation of the Basel's LCR rules—introduces a favourable treatment for covered bonds. The treatment is specific to EU and aims to reflect credit quality, liquidity performance and the role of covered bonds in the funding markets of the EU. It allows covered bonds to be included in Level 1, 2A and 2B liquid assets for the purposes of calculating their LCR under specific criteria. Furthermore, covered bonds can be included up to 70% in the liquidity buffer (leaving 30% for the highest liquid Level 1 assets such as Level 1 government bonds).

The EU implementation of the LCR deviates from the EBA's advice and reports addressed to the Commission in December 2013¹³ in various respects, including in relation to the treatment of covered bonds. The Basel LCR rules set out specific conditions for the inclusion of covered bonds in Level 2A only (covered bonds cannot be issued by the institution itself or its affiliated entities; they must have a rating of at least AA-; and there must be proven marketability even during stressed market conditions with a maximum price decline or haircut increase of 10% in a 30-day stress period). Consistent with Basel and backed by prudential analysis, the EBA advised inclusion of covered bonds in Level 2A only (covered bonds must be rated ECAI1, must have a minimum issue size of EUR 250 million or equivalent, and must be subject to a minimum haircut of 15%).

In line with Basel,¹⁴ covered bonds—independent of their currency—are restricted to Level 2A assets in other countries such as Canada, Australia and Singapore. The United States sets out stricter conditions than Basel, as covered bonds do not qualify for the United States' LCR. Hence, the distinct treatment of covered bonds in the EU allows for the inclusion of a wide range of covered bonds in the liquidity buffer, which are not eligible in Basel-compliant jurisdictions and under the treatment recommended in the EBA's prudential advice. LCR eligibility has been the crucial factor determining banks' investment in covered bonds, which maintains their position as the largest covered bond investors.

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¹² Commission Delegated Regulation (EU) 2015/61 to supplement Regulation (EU) No 575/2013 with regard to liquidity coverage requirements for credit institutions: http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=OJ:L:2015:011:FULL&from=FR.

¹³ The EBA reports on liquidity: (i) the EBA report on the impact assessment for liquidity measures under Article 509(1) of the CRR; and (ii) the EBA report on a ppropriate uniform definitions of extremely high quality liquid assets (HQLA) and HQLA and on operational requirements for liquid assets under Article 509(3) and (5) of the CRR: https://www.eba.europa.eu/-/eba-publishes-reports-on-liquidity.

¹⁴ Basel III: The LCR and liquidity risk monitoring tools: http://www.bis.org/publ/bcbs238.pdf.



Figure 36: Treatment of covered bonds in the LCR across a few countries

	Basel guidelines	Commission's Delegated Act	EBA's advice	United States	Canada	Australia	Singapore
Level 1	-	Extremely high-quality covered bonds if: UCITS- or CRR-compliant, minimum size of EUR 500 million, minimum AA-, minimum 2% overcollateralisation.	-	-	-	-	-
		Level 1 covered bonds maximum 70% of liquidity buffer+ subject to a 7% haircut. These limitations are only applicable to covered bonds and not to other Level 1 asset classes.					
Level 2A	Non-retained covered bonds with minimum AA-, traded in large/deep/active repo or cash markets with proven liquidity track record (i.e. maximum 10% price decline or haircut increase over 30 days).	High-quality covered bonds if: UCITS- or CRR-compliant, minimum size of EUR 250 million, minimum A-, minimum 7% overcollateralisation (limited to 2% for covered bonds not eligible in Level 1B because of minimum size). High-quality non-EU covered bonds if: under a national law and subject to specific public supervision, cover pool transparency and asset types in line with the CRR (i.e. public sector, mortgage, shipping), minimum AA-, minimum 7% overcollateralisation (limited to 2% if minimum size of EUR 500 million). Level 2A covered bonds maximum 40% of the liquidity buffer + subject to a 15% haircut. These limitations are applicable to all Level 2A asset classes.	Rated ECAI 1 with a minimum issue size of EUR 250 million (or equivalent), minimum 15% haircut.		Non-retained covered bonds with minimum AA-, traded in large/deep/active repo or cash markets, with proven liquidity track record (i.e. maximum 10% price decline or haircut increase over 30 days); Canadian structured covered bonds eligible if they meet these criteria.	Non-retained covered bonds with minimum AA-, traded in large/deep/active repo or cash markets, with proven liquidity track record (i.e. maximum 10% price decline or haircut increase over 30 days).	Non-retained covered bonds with minimum AA-, traded in large/deep/active repo or cash markets, with proven liquidity track record (i.e. maximum 10% price decline or haircut increase over 30 days).
Level 2B	-	High-quality covered bonds (no rating minimum) if: UCITS- or CRR-compliant, minimum EUR 250 million size, public sector and residential mortgage cover pools only, 35% maximum risk weighted assets of underlying assets, 10% minimum actual overcollateralisation reported monthly. Level 2B covered bonds maximum 15% of the liquidity buffer (applicable	-	-	-	-	-
		to all Level 2B asset classes). Subject to 30% haircut (haircuts different for different Level 2B asset classes). Additional requirements applicable to all covered bonds: UCITS- or CRR-compliant; must be compliant with transparency requirements of Article 129(7) of the CRR; non-EEA covered bonds must have a national					
Entry into force	60% as of January 2015, 70% January 2016, 80% January 2017, 90% January 2018 and 100% January 2019.	covered bond law. 60% as of October 2015, 70% January 2016, 80% January 2017 and 100% January 2018.		80% as of January 2015, 90% January 2016 and 100% January 2017.	100% as of January 2015.	100% as of January 2015.	60% as of January 2015, 70% January 2016, 80% January 2017, 90% January 2018 and 100% January 2019.

SOURCE: EBA, BAML



Treatment of covered bonds under the BRRD

The BRRD,¹⁵ which entered into force on 1 January 2015, has important direct and indirect implications for covered bonds, particularly as it exempts UCITS-compliant covered bonds from the scope of the bail-in tool, under specific conditions (Article 44(2) of the BRRD). Preferential treatment of covered bonds under the BRRD, which prevents covered bonds from being affected by resolution, has been a principal factor in the adjustment of rating methodologies of all main rating agencies and an increase in covered bond ratings across the EU.

Apart from bail-in, the application of other resolution tools might also have implications for covered bonds, particularly in the context of partial transfer of assets/liabilities to bridge institution or asset management vehicles.

In general, the BRRD provides a very basic framework on how to deal with covered bonds in resolution. It provides essential safeguards to ensure that the structure of covered bonds—and the link between the assets in the cover pool and the liabilities attached to the covered bond—remain intact, and that covered bonds remain generally unaffected by the resolution. The BRRD is, however, silent on a number of specific details relevant from the perspective of covered bonds (e.g. on the treatment of overcollateralisation, valuation). This lack of clarity also allows a certain degree of flexibility for Member States and resolution authorities on how to implement the resolution.

Due to a lack of experience with the implementation of resolution provisions for covered bonds in practice, details of the new resolution regime and its implications for covered bonds remain untested. In addition, covered bond documentation and national legal frameworks may need to be updated in the future to reflect resolution issues, as envisaged under the BRRD.

Bail-in

It is understood that, in most cases, covered bonds would not be affected by resolution, as the covered bond issuer would be recapitalised using the bail-in tool from which covered bonds would be exempted. It should be highlighted, however, that the BRRD limits the exemption of covered bonds from the bail-in up to the level of collateral in the cover pool—i.e. bail-in can be applied to covered bonds in case the liabilities from the covered bonds exceed the corresponding collateral and the resolution authority believes that bail-in for this uncovered part is appropriate. The resolution authority can however use its discretionary power to enable the complete exclusion of covered bonds from the bail-in instrument.¹⁶

¹⁵ Directive 2014/59/EU establishing a framework for the recovery and resolution of credit institutions and investment firms: $\frac{1}{1} \frac{1}{1} \frac{1}$

¹⁶ Such discretionary exclusion requires prior notification to the Commission. The BRRD does not prescribe the maximum amount of liabilities that can be excluded from the bail-in.



A number of issues relating to the treatment of covered bonds under bail-in remain to be clarified, such as: (i) how the collateral value would be valuated (it is presumed that general valuation rules of the failing bank would be followed, as per Article 36 of the BRRD; therefore, the valuation under the BRRD may challenge the valuation of the cover asset pool); (ii) whether voluntary overcollateralisation would be included in the calculation (we understand that decision-making rights for reducing the amount of voluntary overcollateralisation should remain unchanged); (iii) what would be the mechanics of bailing in the covered bond claim in practice (e.g. the size of the contingent claim and in what form the compensation will be provided). In addition, whereas the BRRD stipulates that no creditor should be worse off under resolution, it remains uncertain whether the application of this principle could lead to corrections of decisions already taken.

Partial transfers of asset/liabilities

The BRRD sets out provisions for partial transfers of assets/liabilities of an institution under resolution to another entity, to be exercised in the case of the application of some resolution tools (bridge institution or asset management vehicles). It also provides for safeguards for counterparties to be applied in the case of partial transfers (Article 76), and requests Members States to ensure— in the event of the partial transfers—appropriate protection of covered bonds and to prevent the splitting of assets, right and liabilities that are linked (Article 79). The Commission is to adopt a delegated act further specifying the types of arrangements covered by this safeguard (at the time of writing the report, the delegated act has not been adopted as yet).

The available draft of the delegated act is silent on the treatment of covered bonds in the case of partial transfers, and the BRRD also remains vague in this respect (for example, there is no clarification regarding use of overcollateralisation). This will thus be determined by Member States' implementation of the respective safeguard provided in the Article 79, as well as the final wording of the Commission's delegated act. National implementation of the safeguard should ideally effectively ensure that all property, rights and liabilities that form part of the covered bond programme are transferred together. Clarification of the treatment of overcollateralisation seems also of particular relevance in this respect.

It is understood that partial transfers of assets/liabilities to a new entity would, in most cases, also include covered bonds. In those cases where covered bonds would not be transferred to a new entity, collateral would be left with the covered bond liability. The covered bond issuer would, most likely, be a shell with few assets, which would thus impact the value of dual recourse. However, if there is sufficient overcollateralisation, this option should be economically unattractive to the resolution authority.

Developments in credit rating agencies' rating methodologies and markets

The latest changes in relation to credit rating agencies have not only involved modifications in the rating agencies' methodologies for evaluations of covered bonds, but also an increase in competition with the entry of new rating agencies into the rating market for covered bonds. The impact of these developments on the covered bond market has been very relevant due to the



importance of covered bond ratings, which are still highly embedded in regulation (CRD IV/CRR, Solvency II, ECB repo criteria, LCR Delegated Act), allowing for a preferential treatment under these regulations if specific rating thresholds are reached.

A major development has been an adjustment of rating methodologies by all main credit rating agencies to reflect the implementation of the BRRD and particularly the exclusion of covered bonds from bail-in. The changes have led to a more pronounced de-linkage of covered bonds' ratings from issuers' ratings, which, in most cases, has resulted in upgrades of the ratings and, in turn, enabled better LCR regulatory treatment. There are, however, differences in the specificities of the methodology adjustments among individual rating agencies.

Another important factor resulting in upgrades of ratings, often by a number of notches, has been the trend of improving sovereign ratings and related country ceilings of covered bond ratings in peripheral Europe. This has enabled many covered bonds from countries such as Spain, Portugal, Ireland and Italy to become eligible for the Level 1 liquidity buffer under the LCR Delegated Act, which requires a minimum rating of AA- or equivalent.

Alongside evolving rating methodologies, increased competition has been another important development in the covered bond rating market. DBRS now represents the fourth rating agency in the market and Scope Ratings entered the market and started evaluating covered bonds in Q2 2015.

Innovation and changes in the covered bond structures

Important structural changes have been observed in the covered bond market in the past years, particularly a move from traditional hard bullet covered bond structures (whose maturity cannot be extended) towards an increased use of covered bond structures with extendable maturities.

More concretely, two structures were developed to tackle, in the first place, the liquidity risk of the traditional hard bullets: soft bullet and CPT covered bond structures. Only very few jurisdictions seem to now issue under a hard bullet covered bond structure only; this is true in the case of Germany, Austria, Luxembourg and Spain only. According to the ECBC, the share of structures with extendable maturities (soft bullet and CPT) has raised by nearly 8% from April 2015 to 45% in April 2016.



Figure 37: Main differences between hard bullet, soft bullet, and CPT structures of covered bonds

Hard bullet covered bonds are traditional covered bond structures. Their maturity typically cannot be extended. Failure to pay on the standard maturity date triggers the default and acceleration of all covered bonds in a programme.

Soft bullet covered bonds have a 1-year extended maturity. Failure to pay on the standard maturity date does not trigger the default of the covered bond. The maturity is extended by up to 1 year, setting a new final maturity date, which grants more time to repay the covered bonds. Failure to repay after 1 year at the final maturity date triggers the default and acceleration of all covered bonds in a programme.

In case of **CPT covered bonds,** failure to pay by the standard maturity date does not trigger default of that covered bond. The maturity is extended and the new final maturity date is set, beyond the maximum maturity date of the cover pool assets and usually beyond 30 years (e.g. 38 years in the case of Uni Credit, and 32 years in the case of NIBC and Van Lanschot). The covered bond is switched into pass-through mode, thus avoiding a fire sale of the cover pool.

With respect to the general differences specified above, it is to be noted that currently there is no common EU definition of soft bullet and CPT covered bond structures, and individual characteristics of such covered bonds differ a mong jurisdictions and covered bond programmes.

Soft bullet structures

Soft bullet structures have become a new market standard. In jurisdictions where they are used, banks have either switched to soft bullets for the new series they issued (e.g. BNP Paribas, Crédit Agricole Bank and the Swedish Covered Bond Corporation), have switched their outstanding series of covered bonds into soft bullets (e.g. ABN AMRO Bank and Credit Suisse), or have set up new soft bullet covered bond programmes (e.g. ING Bank and Stadshypotek AB). The trend of issuing soft bullets has also continued to gain momentum with issuers outside the EU, such as Singapore, Korea and Canada, who also use this format.

The soft bullet structures allow the extension of the maturity of the covered bonds as follows: when the issuer of a bond does not have sufficient funds to repay a redeeming bond at the scheduled maturity, the issuer or the administrator (depending on the structure) can partially redeem the bond and extend the maturity for the remaining balance. The extension of the maturity can happen either before or after the issuer defaults, depending on the covered bond issuance model (for SPV structures, the extension happens after the issuer defaults, while for the balance sheet covered bond issuance models, triggering of the extension does not automatically lead to the issuer's default). The issuer/administrator usually continues to pay further partial payments to investors, on a monthly basis. The mechanism only affects the specific soft bullet bond that is due, while covered bonds that mature at a later stage retain their original maturity dates. In case the remaining balance of the bond whose maturity had been extended is not repaid at the final maturity date, the covered bond defaults, which causes an acceleration of all other outstanding covered bonds in the programme.

All the soft bullet structures are currently contractually based—i.e. they are not enshrined in statutory law. So far, only the covered bond law in Poland has introduced a structure combining soft bullet and CPT features in their statutory law, following an amendment that entered into force in January 2016. In Germany, an industry proposal has been submitted to include a specific maturity deferral option in the covered bond legislation, with some distinct features from classic soft bullet structures (e.g. not allowing automatic extension of the maturity).



CPT structures

Although CPT covered bond structures were used during the financial crisis (e.g. in retained covered bonds by a few Greek issuers), the NIBC' was the pioneer of the first CPT, issued in October 2013, followed by further benchmark-sized issues in April 2014 and April 2015. CPTs gained momentum in 2015, with UniCredit converting to CPT in February 2015, Van Lanschot issuing a new CPT programme in April 2015, and Banca Monte dei Paschi di Siena transforming its programme into a CPT programme in June 2015. Further CPT programmes followed in Portugal (Novo Banco in October 2015) and the Netherlands (Aegon Bank in November 2015). In 2016, we have seen an introduction of a CPT programme at Austrian Anadi Bank and at Portuguese Caixa Económica Montepio Geral. In general, the issuers either converted existing covered bond programmes into CPT or established programmes in CPT format from the very beginning.

Figure 38: Recent CPT covered bond programme structures

Date	Issuer country	Issuer	Conversion / New programme
October 2013	Netherlands	NIBC	New programme
February 20 15	Italy	Uni Cre dit	Conversion
April 2015	Netherlands	Van Lanschot	New programme
June 2015	Italy	Banca Monte die Paschi di Siena	Conversion
October 2015	Portugal	Novo Banco	New programme
November	Nothorlands	etherlands Aegon Bank	Newprogramme
2015	Netherianus		New programme
2016	Austria	Anadi Bank	New programme
2016	Portugal	Caixa Económica Montepio Geral	Conversion
2016	Poland	Covered bond law introduces soft bullet/CPTs for all covered bonds	New programme

SOURCE: COVERED BOND SCOPE RATING, THE ECBC

In contrast to soft bullet structures that aim to address the liquidity issues from a short term perspective, the CPT structures seek to eliminate the risk altogether by introducing long-term maturity extension periods and switching the affected bonds to the pass through mode. This effectively enables the covered bond to be repaid according to the amortisation profile of the cover assets after entering the pass through mode, without triggering a default of the covered bond, and at the same time to receive a favourable assessment by the rating agencies.

In case of CPT, the extension of the maturity takes place after the issuer's default, once the administrator does not have sufficient funds to redeem the bond at the scheduled maturity date. Similarly as in the case of soft bullets, not all the bonds necessarily need to switch to the pass through at once and later maturing bonds retain their original maturity dates. The administrator attemts to sell part of the cover pool every six months and in case he manages to redeem the extended bond in full before the next bond becomes due, the programme behaves as if no



extension has taken place. However, in case of insufficient funds to repay, the next bond switches to pass through as well.

Many of the CPT structures involve some types of pre-maturity amortisation tests, following the issuer's default and set up for the benefit of the remaining outstanding covered bonds. The tests do not have uniform or standard features and have varying implications from one programme to another (although they normally involve the test of the overcollateralisation level above 0%). Generally, the breach of the test leads to all affected covered bonds in the programme turning into the pass through mode.

Whilst still rather a niche product, CPT structures are becoming increasingly popular, especially from the issuers' perspective, as they mitigate the liquidity and maturity mismatch risks associated with covered bonds. They can help reduce the probability of default of covered bonds by adjusting cash outflows to match cash inflows, which enables issuers to maintain lower overcollateralisation and in turn also to reduce asset encumbrance. They also allow issuers to reach high ratings, as rating agencies de-link the covered bond rating from that of the issuer and positively evaluate limited refinancing risks associated with CPTs. Furthermore, due to high ratings, CPTs currently are CBPP3 eligible and benefit from favourable regulatory treatment (taking into account that European legislation currently does not differentiate between CPT, hard or soft bullet covered bonds, and is reliant on ratings).

CPT formats are attractive from investors' perspective as well, especially due to the same regulatory treatment as hard bullet structures. They, however, incorporate various risks that warrant consideration. In particular, they involve high complexity relating to long theoretical maturity and the complex amortisation profile of cover pools. They may pose difficulties for investors in the pricing of such CPT covered bonds. In addition, they reallocate the refinancing risk of cover assets to investors, which may pose significant risk of illiquidity for the investors. All in all, the complexity of the structures that essentially introduce changes to the structural characteristics of the covered bond product on one hand, and the absence of specific regulatory treatment at the EU level that would address the distinct characteristics of the new products on the other hand, give rise to significant prudential and regulatory concerns.

Moreover, this highlights the importance for investors to fully understand CPT products and the rationale for issuers to issue such structures, as well as the importance of enhancing transparency of the structures of covered bonds and their repayment profiles.



Market initiatives towards increasing transparency and disclosure

In the past few years, several market initiatives have been undertaken with the view of enhancing disdosure and transparency on covered bond markets, among which are the European Transparency Standards initiative developed by the investors' associations, CBIC and ICMA (first templates published in 2012), as well as the ECBC's initiatives such as the Covered Bond Label and NTTs (operational since January 2013) and the HTT (operational since January 2016).

Altogether, 14 NTTs have been developed by 14 jurisdictions and their use has been set as one of the conditions for covered bond issuers in these jurisdictions to apply for the Covered Bond Label. As of August 2016, 91 labels were granted to 77 issuers from the 14 countries, covering EUR 1.4 trillion of covered bonds outstanding.

In the 2014 EBA report, the EBA acknowledged that, while constituting a valuable starting point for the harmonisation of disclosure standards, NTTs incorporated various weaknesses—particularly, they were not aligned with the disclosure templates created by investors' associations (i.e. CBIC and ICMA) nor with the disclosure requirements under Article 129(7) of the CRR (which specifies information that covered bond investors must receive from the issuer to seek preferential risk weight treatment on their covered bond investments).

In the report, the EBA recommended that the legal/regulatory covered bond framework should require covered bond issuers to disdosure aggregate data on credit, market and liquidity risk characteristics of the cover assets and covered bonds, as well as other relevant information—including the levels of contractual and voluntary overcollateralisation—to allow investors to carry out a comprehensive analysis. The EBA also recommended a disclosure at least on a quarterly basis. Furthermore, it recommended that the disclosure criteria in Article 129(7) of the CRR be specified in the technical standards, which would allow for the inclusion of additional variables if appropriate.

Following the limitations identified in relation to NTTs, the HTT has been developed and replaced NTTs as of 1 January 2016. The HTT is a binding requirement for the granting and renewal of the Covered Bond Label with a phase-in period of 1 year. The reporting based on the HTT will be at least on a quarterly basis.

The HTT addresses a number of shortcomings identified by investors in relation to NTTs. It present cover pool information in a harmonised format, which allows for both the recognition of national specificities and the comparability of information required to facilitate investors' due diligence. It requires harmonised definitions by issuers and disclosure of key details such as regulatory treatment, maturity structures, involved counterparties and levels of committed overcollateralisation (it should be noted no loan-by-loan data is disclosed, as this was only requested by a small minority of investors).

Addressing the weaknesses of NTTs as identified in the 2014 EBA report, as well as by the market participants, the HTT is considered a welcome market initiative that incorporates a number of disclosure requirements in line with the recommendations in the EBA report.



Once fully implemented by end 2016, it is expected that the HTT will have a direct impact on more than 70% of covered bonds compliant with CRR, in Europe and globally. Singapore was the first country to launch the HTT in February 2016, followed shortly after by several issuers across Europe—e.g. France, Italy, Spain and the United Kingdom. Other EU and non-EU countries plan to implement the HTT in due course, making the HTT a global transparency product.

2.3 Overview of upcoming regulatory developments with possible implications for covered bonds in the near future

The following section provides an overview of recently finalised, ongoing and upcoming regulatory initiatives that are expected to have implications for covered bonds in the near future. They include the ESAs' RTS on risk mitigation techniques for OTC derivative contracts not deared by a CCP, ESAs' ITS on mapping of ECAIs' credit assessments and the Commission's public consultation. They also refer to the EBA recommendations on the holistic review of the regulatory framework, which also has direct relevance to covered bonds.

The EBA recommendation on the holistic review of the regulatory framework

On 7 July 2015, the EBA published a report and advice to the Commission on a framework for qualifying securitisation.¹⁷ In the first recommendation to the Commission, the EBA recommends undertaking a holistic (i.e. cross-product and cross-sector) review of the regulatory framework and of the proposed reforms relating to various investment products, including covered bonds and securitisation.

The EBA underlined that the review should take into account the relative treatment of securitisation and covered bonds, considering different objectives of the applicable regulatory frameworks. Furthermore, the EBA noted that the capital requirements for securitisation and covered bonds should be calibrated to reasonably conservative standards and be lined to the risk of the corresponding exposures. The capital requirements should also be broadly consistent with the capital requirements for the underlying portfolio, while taking into account the different structural, transparency and risk-specific characteristics of the debt products. The EBA also noted that the differences in regulatory treatment have significant impact on incentives to issue/invest in the respective instruments from both an issuer's and an investor's perspective, and it recommended to the Commission to take action following the systemic review (where appropriate).

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 $^{^{17} \} The \ EBA \ report \ on \ qualifying \ s \ ecuritisation: \\ \underline{https://www.eba.europa.eu/-/eba-issues-advice-on-securitisation}.$



RTS on risk mitigation techniques for OTC derivative contracts not cleared by a CCP

The final draft ESAs' RTS on risk mitigation techniques for OTC derivative contracts not cleared by a CCP¹⁸—developed under Article 11(15) of the EMIR regulation—specify risk mitigation techniques, including the exchange and proper segregation of collateral for that class of derivatives, and set out specific provisions for those derivative contracts associated with covered bonds used for hedging purposes.

The senior rights of covered bond investors often prescribed by existing covered bond regulations across the EU may prevent giving the derivative counterparty a preferential claim to assets in the cover pool over the covered bond investors. Since this might be incompatible with the margin exchange, the RTS thus allow for some flexibility to covered bond issuers or the cover pool, while providing the derivative counterparty with a certain level of protection.

In fact, Recital 24 of EMIR highlights that, under certain conditions, a covered bond's assets may provide equivalent protection against counterparty credit risk. Therefore, the RTS prescribe a specific set of conditions (Article 30(2)) under which covered bond issuers or the cover pool may be subject to preferential treatment. For preferential treatment to be applicable, all the conditions have to be met at the same time by the covered bond issuers or the cover pool. These conditions are the following: (a) the OTC derivative contract is not terminated in case of resolution or insolvency of the covered bond issuer or cover pool; (b) the counterparty to the OTC derivative conduded with covered bond issuers or with cover pools for covered bonds ranks at least pari passu with the covered bond holders except where the counterparty to the OTC derivative concluded with covered bond issuers or with cover pools for covered bonds is the defaulting or the affected party, or waives the pari passu rank; (c) the OTC derivative contract is registered or recorded in the cover pool of the covered bond in accordance with national covered bond legislation; (d) the OTC derivative contract is used only to hedge the interest rate or currency mismatches of the cover pool in relation to the covered bond; (e) the netting set does not include OTC derivative contracts unrelated to the cover pool of the covered bond; (f) the covered bond to which the OTC derivative contract is associated meets the requirements of Artide 129(1), (2) and (3) of the CRR; (g) the cover pool of the covered bond to which the OTC derivative contract is associated is subject to a regulatory collateralisation requirement of at least 102%.

It has to be noted that all the conditions should be met at the same time. In addition, the condition on overcollateralisation can be considered met only where it is prescribed in national regulation; voluntary or contractual overcollateralisation cannot be taken into account to obtain preferential treatment.

¹⁸ ESAs' RTS on risk mitigation techniques for OTC derivative contracts not cleared by a CCP, developed under Article 11(15) of Regulation (EU) No 648/2012: https://www.eba.europa.eu/regulation-and-policy/market-infrastructures/draft-regulatory-technical-standards-on-risk-mitigation-techniques-for-otc-derivatives-not-cleared-by-a-central-counterparty-ccp-">https://www.eba.europa.eu/regulation-and-policy/market-infrastructures/draft-regulatory-technical-standards-on-risk-mitigation-techniques-for-otc-derivatives-not-cleared-by-a-central-counterparty-ccp-



Where those conditions are met, covered bond issuers or cover pools are (i) exempted from posting variation margins; and (ii) exempted from posting and collecting initial margin. However, covered bond issuers or cover pools are required to collect variation margins in cash and to return the collected amount where it is no longer due.

The final draft RTS were developed line with the mandate in Artide 11(15) of EMIR and published by the ESAs in March 2016. The Commission has proposed amendments to the final draft RTS, to which the EBA submitted its opinion in September 2016. The final RTS were adopted by the Commission in October 2016¹⁹ and are expected to enter into force in December 2016.²⁰

ITS on mapping of ECAIs' credit assessments

The draft ITS on the mapping of ECAIs' credit assessment — as developed by the Joint Committee of the ESAs under Article 136(1) and (3) of the CRR and Article 109a(1) of the Solvency II Directive will also have a direct relevance for covered bonds and the calculation of own fund requirements for covered bond exposures under the standardised approach to credit risk. The ESAs finalised and submitted final draft ITS to the European Commission in November 2015²¹.

The draft ITS under the CRR set out the correspondence (i.e. 'mapping') between the credit assessments of ECAIs (via credit quality steps - CQSs) and the risk weights of non-securitisation exposures, under the standardised approach to credit risk in the CRR²². These draft ITS also stipulate factors, both quantitative and qualitative, and benchmarks that should be taken into account to produce such mappings. Furthermore, the draft ITS are accompanied by 26 ECAIs' mapping reports that contain explanations of how the ITS principles have been employed in each ECAI's case to produce the mapping.

In the context of covered bonds, credit ratings assigned by ECAIs to these types of exposures are also covered by the mappings under these draft ITS. Institutions should therefore consider the relevant mappings provided as part of these ITS when calculating their capital requirements for credit risk on covered bonds when using the standardised approach.

These draft ITS set out default rates as the main quantitative factor that characterises the risk underlying credit assessments of ECAIs. In particular, these draft ITS specify how short-run and

<u>delegated-act_en.pdf</u>

The final RTS will apply from one month after the date of entry into force, for initial margin and variation margin for counterparty a bove 3000 bn EUR. For counterparty below the 3 000 bn EUR threshold, the variation margin will apply from the date that is the latest of 1 March 2017 or 1 month following the date of the entry into force of the RTS, and for initial margin according to the international timeline a greement set in the RTS.

²¹ Draft ITS on the mapping of ECAIs' credit assessment, developed under the

CRR:http://www.eba.europa.eu/regulation-and-policy/external-credit-assessment-institutions-ecai/draftimplementing-technical-standards-on-the-mapping-of-ecais-credit-assessments; draft ITS developed under the Solvency II Directive: https://eiopa.europa.eu/Publications/Technical%20Standards/JC%202015%20068%20-%20Final%20Draft%20ITS%20on%20ECAls%20mapping%20under%20Solvency%20II.PDF.

The draft ITS under the Solvency II Directive apply, mutatis mutandis, the mapping under the CRR to the insurance frame work. The only difference is that the mapping under the Solvency II Directive is characterised by seven CQSs, compared to the six CQSs under the CRR framework.



long-run default rates of rating categories shall be calculated and compared with the benchmarks when performing the mapping, and how short-run default rates should be used for monitoring purposes.

These draft ITS also proposed a specific treatment for ECAIs for which there is limited quantitative data available on their rating history (which is usually the case for small and newly established ECAIs). For these ECAIs, with a view of striking a balance between prudential and market competition objectives, the draft ITS put forward by the ESAs proposed the application of a phase-in period of three years until 31 December 2018 in which those ECAIs with small pools of ratings were granted mappings based on relaxed quantitative requirements. Following this phase-in period, the ESAs proposed to prescribe the application of non-relaxed quantitative requirements. As a consequence, the draft ITS developed by the ESAs proposed two mappings for those ECAIs for which there is limited quantitative data available.

The Commission proposed amendments to the draft ITS put forward by the ESAs, in particular it proposed the removal of non-relaxed quantitative requirements to be applied for ECAIs with small pools of rating data at the end of the phase-in period, thus extending indefinitely the validity of mappings based on relaxed quantitative requirements applied in the first 3 years also afterwards.²³

Subsequently, in October 2016 the Commission finally adopted the ITS under the CRR and Solvency II Directive²⁴. As a consequence, credit ratings issued by the ECAIs covered by these ITS may now be used by institutions for calculating capital requirements of institutions and insurance undertakings in accordance with the mappings established in those ITS. Nevertheless the ITS as adopted by the Commission did not take the ESAs' opinion into account, and retained the application of non-related quantitative requirements following the elapse of the phase-in period. The ITS entered into force in October 2016.

The Commission's consultation on covered bonds

the mandate of the ESAs.

As part of its Capital Markets Union initiative, the Commission launched a public consultation on 30 September 2015 on the possible development of an integrated European covered bond

²³ The amendments proposed by the Commission were driven by the policy objective of promoting market competition in the credit rating industry. In May 2016, the ESAs submitted an Opinion to the Commission in response to the proposed amendments to the final draft ITS (available under https://www.eba.europa.eu/-/esas-clarify-their-position-on-technical-standards-on-the-credit-quality-steps-for-ecais-credit-assessments), in which the ESAs expressed their disagreement with the amendments on the grounds that they would ultimately jeopardise the prudential purposes of the mappings and would be prone to underestimation of capital requirement for institutions. The ESAs noted that favouring competition over prudential considerations increases risk to financial stability and would not be in line with

²⁴ Final ITS as a dopted by the Commission a vailable under http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv:OJ.L_.2016.275.01.0019.01.ENG&toc=OJ:L:2016:275:TOC for the CRR and Solvency II Directive, respectively.



framework.²⁵ In the consultation, the Commission took on board many of the EBA's best practice recommendations on national frameworks as made in the July 2014 report, having recognised that disparity between legal frameworks and supervisory practices of the various Member States may be of hindrance and result in obstacles to market depth, liquidity and investor access. The consultation paper explores the case for a more integrated covered bond framework and presents two main policy options for the integration of the covered bond markets:

- First, voluntary convergence of Member States' covered bond laws via non-legislative coordination measures, such as targeted non-binding Commission recommendations that would implement the EBA's best practices in national legal frameworks;
- Second, a direct EU legislative framework on covered bonds that would harmonise existing national laws and regulate covered bonds as a legal instrument rather than just regulating their prudential treatment. The paper suggests the following three possible instruments under this option: a directive; a directly applicable regulation that would at least partly replace the covered bond laws of Member States; and a comprehensive EU law framework for covered bonds that would act as a '29th regime' alternative, running alongside existing national frameworks.

The consultation paper also discusses a high-level design for a hypothetical EU covered bond framework, and consults on each of the proposed elements of the possible framework, building on the structure and the proposals made in the EBA report:

- Covered bond definitions and protection of the term;
- Covered bond issuers and system of public supervision: issuer models and licensing requirements and the role of SPVs; ongoing supervision and cover pool monitoring (preinsolvency); and covered bond and the Single Supervisory Mechanism (SSM);
- Dual recourse and insolvency/resolution regime: definition of the dual recourse principle; segregation of cover assets; administration and supervision of the cover pool post-insolvency; and interaction between the cover pool and the issuer in an insolvency/resolution situation;
- Cover pool: qualifying criteria and requirements for eligible assets; coverage requirements and overcollateralisation; and market and liquidity risks related to cover/asset liabilities risk mitigation;
- Transparency requirements.

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Link to the Commission's page on the public consultation: http://ec.europa.eu/finance/consultations/2015/covered-bonds/index_en.htm. Link to the consultation document: http://ec.europa.eu/finance/consultations/2015/covered-bonds/docs/consultation-document_en.pdf.



The public consultation ended on 6 January 2016. Altogether, 72 responses were submitted. 26

The Commission is currently in the process of considering future action on harmonisation. In the Capital Markets Union communication from 14 September 2016, the Commission recognised the importance of covered bonds for the long term financing of the real economy and, in particular, of the real estate sector. The Commission announced that based on the results of the recent public consultation and ongoing study, it will set out as part of the CMU mid-term review which legislative changes may be needed to support the development of covered bond markets throughout the EU.

International developments

Discussions are ongoing at an international (Basel) level, which will also have implications on covered bonds, such as discussions on the revision of the standardised approach, as well as a strategic review of internal models including the potential introduction of a capital floor for internal models.

 26 Link to responses to the consultation authorised for publication: $\underline{\text{https://ec.europa.eu/eusurvey/publication/covered-bonds-2015?surveylanguage=en}}$.

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Chapter 3: Three-step approach to the harmonisation of covered bond frameworks in the EU

3.1 Rationale and objective of the EBA's proposal on the harmonisation of covered bond frameworks in the EU

Based on the analysis of the latest market and regulatory trends and developments in the national covered bond frameworks, the following conclusions can be drawn:

- The dynamics in covered bond markets confirm the position of covered bonds as key funding
 instruments of the EU economy. Despite global expansion of covered bonds, European credit
 institutions continue to lead in covered bond issuance;
- The market and regulatory developments in the past two years confirm the traditional positive approach of both regulators and market participants towards the covered bond model. The existing EU banking prudential regulation continues to be covered bond-friendly, allowing banks' exposures to covered bonds to benefit from specific and favourable treatment. In addition, merits of the covered bond instrument have been recently recognised at the global level, which further underlines the importance of monitoring and maintaining the quality of the product;
- The recent market developments may give rise to some prudential considerations, particularly: (i) innovations in covered bond structures that essentially change the characteristics of the product (while they are not subject to specific regulatory treatment at the EU level and benefit from the same regulatory rules as traditional covered bond products); and (ii) covered bond instruments with different quality characteristics across the EU that are eligible for the same favourable regulatory treatment;
- Regulatory and market developments are particularly intertwined in the case of covered bonds. As such, dynamics of covered bond markets have been considerably affected by new EU prudential requirements in place, particularly in the area of liquidity, and by continued extraordinary monetary policy measures in the euro area.

Furthermore, the assessment of national covered bond frameworks and an analysis of the implementation of EBA's best practices by individual jurisdictions have confirmed existing diversity in the legal, regulatory and supervisory covered bonds frameworks across EU. In addition, it shows a divergence in the alignment with the best practices among individual jurisdictions. While the analysis demonstrates a strong adherence across Europe to the core pillars of the covered bond business (related to dual recourse and the coverage principle), there



are significant variances in the regulatory frameworks in the area of special public supervision as well as in relation to the scope and frequency of the disclosure of data on cover assets and covered bonds, liquidity buffers to address liquidity risks associated with covered bond programmes, composition of the cover pool and stress testing on calculation of the coverage requirement.

Last but not least, it has been observed that less than half (10 out of 22) of the respondent jurisdictions have undertaken action since the publication of the 2014 EBA report to amend their covered bond frameworks. Pending the results of the Commission's review, majority of jurisdictions (12 out of 22) have either not taken action or the action has been put on hold.

Building on the condusions of the EBA's analysis (confirming in particular existing diversity in national covered bond frameworks, significant market and regulatory developments with direct impact on the covered bonds and the importance of covered bonds in funding the EU economy), the EBA considers it relevant to incentivise harmonisation of the covered bond frameworks and proposes a three-step approach to achieve this objective.

Importantly, the proposed three-step approach builds on the strengths of the existing national frameworks, but allows better protection of the 'covered bond brand' by ensuring more consistency in definition and regulatory treatment of covered bond products throughout the EU, so that only those financial instruments that comply with the harmonised structural, credit risk and prudential standards can be branded covered bonds and can have access to special regulatory treatment and preferential risk weights, as offered in the current EU financial regulation.

All in all, the proposal should provide a balanced solution towards minimum harmonisation of national covered bond frameworks at the EU level, allowing the meeting of prudential objectives while building on existing well-functioning national covered bond markets, keeping flexibility and specificities of national covered bond frameworks and leaving room for varying national implementation (where appropriate).

The proposal of a three-step approach has not been subject to a cost and benefit analysis. In case a legislative proposal is developed taking into account the EBA proposal, an impact assessment should be conducted in line with standard and well-established legislative procedures. Such impact assessment should cover all the main recommendations in the proposal and it should also specifically assess the implications of the liquidity buffer (with a specific focus on the recommendations regarding soft bullets and CPTs), level of overcollateralisation, and eligibility of ship loans as a cover asset for the purposes of preferential capital treatment.



3.2 Current EU covered bond legislation

The current EU covered bond regulation is laid down in a number of EU legislative acts. The two core legislations are the UCITS Directive, which defines the core features of the covered bond product, and the CRR, which (most importantly) sets out preferential risk weight treatment for UCITS-compatible covered bonds meeting specified conditions.

The LCR Delegated Act, the BRRD and the RTS on risk mitigation techniques for OTC derivative contracts not cleared by a CCP set out conditions for specific regulatory treatments of UCITS/CRR-compatible covered bonds in relation to resolution matters, liquidity requirements and margin requirements.

The UCITS Directive (Article 52(4))²⁷ defines the following conditions necessary for a bond to be defined as a covered bond:

- Issuer characteristics The bond must be issued by a credit institution that has its registered office in a Member State;
- Dual recourse principle Sums deriving from the issue of those bonds shall be invested in
 accordance with the law in assets that, during the whole period of validity of the bonds, are
 capable of covering claims attaching to the bonds and that, in the event of failure of the
 issuer, would be used on a priority basis for the reimbursement of the principal and payment
 of the accrued interest;
- Special public supervision The issuer of the covered bond must be subject, by law, to special public supervision to protect the bondholders.

Article 52(4) of the UCITS Directive:

'Member States may raise the 5% limit laid down in the first subparagraph of paragraph 1 to a maximum of 25% where bonds are issued by a creditinstitution which has its registered office in a Member State and is subject by law to special public supervision designed to protect bondholders. In particular, sums deriving from the issue of those bonds shall be invested in accordance with the law in assets which, during the whole period of validity of the bonds, are capable of covering daims attaching to the bonds and which, in the event of failure of the issuer, would be used on a priority basis for the reimbursement of the principal and payment of the accrued interest."

The CRR²⁸ establishes criteria in Article 129 that need to be fulfilled—in addition to those foreseen under the UCITS—for covered bond investors (credit institutions or investment firms) to be granted preferential risk weight treatment on their covered bond investment. The criteria relate to (i) collateral (Article 129 specifies types of eligible underlying assets); and (ii) disdosure (Article 129 sets out disdosure requirements for the issuer to disdose information to the investor). Additionally, the CRR sets out valuation criteria for exposures collateralised by immovable property in Article 208 and Article 229(1), via Article 129(3), which equally need to be

 $\frac{17.}{28}$ The CRR, Regulation No 575/2013 on prudential requirements for credit institutions and investment firms: $\frac{\text{http://eur-lex.europa.eu/legal-content/EN/TXT/?qid=139583588223&uri=CELEX:32013R0575}$.

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²⁷ UCITS Directive, Directive 2009/65/EC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities: http://eur-lex.europa.eu/eli/dir/2009/65/2014-09-17.



complied with for the purposes of preferential risk weights. Furthermore, some specific derogations apply to some cover assets as per Article 496 of the CRR.

The CRR sets out the risk weights of such preferential risk weight treatment, with regard to the standardised approach to credit risk (Article 129), preferential loss given default (LGD) treatment of exposures in the form of covered bonds under the (foundation) internal ratings-based (IRB) approach (Article 161(1)(d)), as well as preferential specific risk treatment (Article 336(3)).

In addition, the CRR stipulates specific provisions in relation to covered bonds compliant with UCITS and Article 129 of the CRR under (i) the financial collateral framework (Article 207) according to which retained covered bonds qualify as eligible collateral when they are posted as collateral for a repo transaction; and under (ii) the large exposures regime (Article 400) according to which covered bonds may be fully or partially exempted from large exposure requirements.

- The LCR Delegated Act,²⁹ which entered into force on 1 October 2015, allows for the inclusion
 of covered bonds in the liquidity buffer (more concretely, it allows the inclusion of covered
 bonds compliant with the UCITS and CRR criteria in Level 1 and Level 2A of the liquidity buffer
 and covered bonds compliant with the UCITS criteria in Level 2B assets, under specific
 conditions).
- The BRRD,³⁰ which entered into force on 1 January 2015, allows for the exemption of covered bonds, as defined by the UCITS, from the bail-in instrument (the exemption is limited up to the level of collateral in the cover pool), as well as the establishment of safeguards when applying resolution instruments to the covered bonds.
- The RTS on risk mitigation techniques for OTC derivative contracts not cleared by a CCP, developed under EMIR, provide for a specific treatment of cover pool derivatives (derivatives entered into by covered bond issuers for the hedging of the cover pool's market risks and included within the scope of the protective measures established by the respective covered bond regime). The RTS set out a specific set of conditions under which such cover pool derivatives, which are concluded with regard to covered bonds compliant with Article 129 of the CRR, are exempted from margin requirements in the context of bilateral dearing (i.e. clearing not executed through a CCP).

To sum up, the core elements of the EU covered bond definition are regulated by the UCITS Directive and the CRR, while other pieces of European legislation set out specific treatments for covered bonds compliant with either the UCITS and/or the CRR.

²⁹ Commission Delegated Regulation (EU) 2015/61 to supplement Regulation (EU) No 575/2013 with regard to liquidity coverage requirements for credit institutions: http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=OJ:L:2015:011:FULL&from=FR.

³⁰ The BRRD, Directive 2014/59/EU establishing a framework for the recovery and resolution of credit institutions and investment firms: http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv:OJ.L...2014.173.01.0190.01.ENG.

³¹ Commission Delegated Regulation (EU) supplementing Regulation (EU) No 648/2012 with regard to RTS for risk-mitigation techniques for OTC derivative contracts not cleared by a CCP: http://ec.europa.eu/finance/financial-markets/docs/derivatives/161004-delegated-act_en.pdf



The core elements of the covered bond definition enshrined in the existing EU legislation—including the dual recourse structure, the coverage principle, as well as special public supervision and covered bond investors' protection—have been incorporated in a diverse manner in national legal and regulatory frameworks, with a variety of additional specifications.

The principles of best practice identified by the EBA in the 2014 EBA report have been developed to cover crucial areas of the covered bonds regulation that are currently not sufficiently reflected at the EU level and are addressed at national level according to a wide range of approaches. The EBA's best practice recommendations have been based on common patterns observed and strengths identified in most of the developed national frameworks.

3.3 The EBA's suggestion for a three-step approach to the harmonisation of covered bond frameworks

The EBA recommends a three-step approach to the harmonisation of covered bond frameworks in the EU—i.e. it recommends strengthening the currently applicable regulatory rules in relation to covered bonds and harmonising practices observed in various areas of covered bond business within one of the following three steps:

- Within Step I—i.e. in the newly developed covered bond framework, which would provide
 a definition of the covered bond product as an instrument recognised by the EU financial
 regulation (implementation via directive is recommended). All covered bonds seeking
 regulatory recognition would need to comply with the requirements specified in Step I;
- Within Step II—i.e. through targeted amendments to the CRR provisions on covered bonds, which would enhance conditions for the access to preferential risk weight treatment of covered bonds. All covered bonds seeking preferential risk weight treatment would need to comply with the requirements specified in the Step I as well as in Step II;
- Within Step III—i.e. through non-binding instruments with a view of stimulating voluntary convergence between national frameworks in specific areas (taking into account that non-compliance with the recommendations in this area would not have impact on the eligibility of the covered bonds for preferential regulatory and risk weight treatment).

This approach builds substantially on the best practice recommendations identified in 2014, as all of the areas covered by the best practices are treated in one of the three steps (whereby the choice of the most appropriate stage is dependent on the nature and ultimate rationale of each best practice considered). The best practices are developed from high-level principles to more specified criteria, where appropriate. The three-step approach also involves other areas not covered by the EBA's best practice, and inclusion of which is considered important to strengthen the robustness of the overall framework.



In the development of the framework, due considerations should also be given to interactions between Level 1 and Level 2 in the context of the Lamfalussy process (especially with respect to areas covered in Step I and Step II), in view of achieving an appropriate balance between establishing the core requirements at Level 1, while allowing technical clarifications in Level 2 measures.

The EBA also recommends introducing a grandfathering provision (similar to the one currently set out in Article 129(6) of the CRR) so as to enable covered bonds that would be issued and would be eligible for preferential treatment since a cut-off date (prior to the entry into force of the new covered bond legislation) to remain eligible for such preferential treatment until maturity, irrespective of whether or not they would meet the new proposed requirements. The EBA recommends including a similar grandfathering provision in the LCR Delegated Act.

Step I – Development of a covered bond framework

Rationale

The first step envisages the development of a covered bond framework, the objective of which would be to define the covered bond as an instrument recognised by EU financial regulation. The covered bond framework should specify the core elements of the covered bond mechanism and a set of minimum quality standards of regulated covered bonds. This would provide a single, consistent and sufficiently detailed point of reference for prudential regulation purposes, effectively replacing all the existing covered-bond-related provisions in the UCITS Directive (presented in Article 52(4)). Taking this into account, the covered bond framework should be applicable across different financial sectors and be based on the minimum harmonisation principle.

All the financial instruments in the EU that seek to be recognised as covered bonds across all EU financial regulation would have to comply with these minimum standard requirements. This would effectively distinguish covered bonds from other types of bond instruments that might exist at the EU or national levels and which might have some similar characteristics but do not comply fully with all the quality characteristics.

In addition, all other European regulations that set out specific treatments for covered bonds (such as inclusion of covered bonds in the LCR liquidity requirements, exclusion of covered bonds from bail-in under the BRRD, and exemption of cover pool derivatives from margin requirements under the RTS on risk mitigation techniques for OTC derivatives not cleared by a CCP) should make reference to the covered bond instrument as defined in the covered bond framework.

The standards specified in the covered bond framework would inevitably include most of the characteristics that market participants currently and historically have been attaching to the label and reputation of a regulated covered bond. However, it should be clarified that this would not include all the standards that currently define a CRR-compliant covered bond—i.e. a covered



bond that is eligible for preferential risk weight treatment according to banking regulation. Preferential risk weight treatment would still be determined by banking sectoral legislation (i.e. by the CRR in the context of Step II) on the basis of specific requirements to be considered in a modular fashion on top of the minimum standards provided in the covered bond framework.

Areas covered

The covered bond framework should replicate and further specify the aspects currently regulated in the UCITS Directive that define the covered bond product, as well as include other additional elements—predominantly of structural nature and not covered by the UCITS Directive, including specific conditions for soft bullet and CPT covered bonds—that are considered relevant for underpinning minimum standards of quality.

The framework should be applicable to covered bonds issued by credit institutions having their registered office in a EU Member State (as currently required under the UCITS Directive). Subject to establishment of a mechanism for assessing equivalence of the covered bond instruments³², a possibility could be explored to allow the 3rd country covered bonds to have access to the same regulatory treatment as currently extended to covered bonds issued by credit institutions in the EU.

This should also allow the capturing of all the aspects that would justify a specific regulatory treatment of covered bonds compliant with this definition, under the specific EU financial regulations (e.g. in relation to liquidity, resolution and margin requirements, as specified above).

More concretely, the areas covered in the covered bond framework should be as specified in Figure 39.

Figure 39: Areas covered in Step I (covered bond framework)

Areas covered in Step I (covered bond framework)

Relation to the current regulatory treatment (new rule - not covered by current EU legislation; extension/amendment of the

		existing rule)			
Dualre	Dual recourse, segregation of cover assets and bankruptcy				
remote	ness of covered bonds:				
	Dualrecourse	Extension/amendment of the existing rule			
a.		(UCITS Directive – Art. 52(4))			
b.	Segregation of cover assets	New rule			
c.	Bankruptcy remoteness of the covered bond	New rule			
Requirements on coverage, liquidity risk mitigation and cover pool					
derivatives					
d.	Coverage requirements	Extension/amendment of the existing rule			
		(UCITS Directive – Art. 52(4))			
e.	Li quidity risk mitigation require ments	New rule			
f.	Requirements on cover pool derivatives	New rule			

 $^{^{32} \} The \ principles \ laid \ down \ in \ Artide \ 11 \ (1) \ (d) \ (ii) \ of \ the \ LCR \ Delegated \ Act \ could \ possibly \ be \ considered \ as \ a \ starting$ point in the discussions on the equivalence criteria.



Areas covered in Step I (covered bond framework)

Relation to the current regulatory treatment (new rule – not covered by current EU legislation; extension/amendment of the existing rule)

		<u> </u>		
System of special public supervision and administration				
g.	Cover pool monitor	New rule		
h.	Supervision of the covered bond issuer	New rule		
i.	Supervision in the event of the issuer's	New rule		
	insolvency/resolution	New rule		
j.	Administration of the covered bond programme post the	New rule		
	is suer's insolvency/resolution	New rule		
Trans parency requirements				
k.	Scope and frequency of disclosure	Extension/amendment of the existing rule		
		(CRR – Art. 129(7))		
Conditions for soft bullet and CPT covered bonds		New rule		

Step II - Introduction of targeted amendments to the CRR

Rationale

Within Step II of the suggested approach to the harmonisation of covered bonds, targeted amendments should be introduced to the CRR provisions on covered bonds that would specifically focus on credit risk related features of covered bonds and on the prudential risk weight treatment of investments in covered bonds. All covered bonds that risk weight treatment seek preferential risk weight treatment would need to comply with the standard requirements on covered bonds as specified in Step I, as well as with the enhanced conditions for preferential risk weight treatment as specified in Step II.

Areas covered

The current CRR regulates the following aspects in relation to covered bonds:

- Criteria for investors (credit institutions and investment firms) in covered bonds for
 preferential risk weight treatment of their covered bond investments, these being the
 eligibility requirements for collateral and the disclosure requirements for an issuer
 (Article 129);
- Risk weight treatment under the standardised approach (Article 129), preferential LGD treatment of exposures in the form of covered bonds under the (foundation) IRB approach (Article 161(1)(d)), as well as preferential specific risk treatment (Article 336(3));
- Criteria for the valuation of immovable property collateralising mortgages in cover pools (Article 208 and Article 229(1) via Article 129(3));³³

³³ See also the EBA opinion on the mortgage lending value, 5 October 2015, EBA/Op/2015/17: https://www.eba.europa.eu/-/eba-seeks-legislative-clarifications-on-mortgage-lending-value.



- Specific treatment of covered bonds in the financial collateral framework (Article 207);
- Specific treatment of covered bonds under the large exposure regime (Article 400);
- Derogations on some type of cover assets (Article 496).

In Step II of the approach to the harmonisation of covered bonds, the EBA suggests amending and strengthening the conditions for access to preferential risk weight treatment of investments in covered bonds, as mentioned in the first bullet above. It is not suggested to amend other covered-bond-related provisions of the CRR. More concretely:

- Additional (new) conditions underpinning preferential risk weight treatment should be introduced to establish (i) limits on substitution assets and (ii) requirements on minimum effective overcollateralisation at the covered bond level;
- Existing provisions on LTV limits for cover assets collateralised by physical property (i.e. for mortgage cover pools) should be amended so as to specify the type of the limits (while the current levels of the LTV limits should be maintained);
- Existing provisions on disclosure requirements for the issuer should be amended and shifted
 to the covered bond framework (Step I), and should thus become a standard requirement for
 all regulated covered bonds, rather than a specific condition only for those covered bonds
 seeking preferential risk weights;
- Existing provisions on the eligibility of cover assets should be reassessed.

All in all, taking into account the EBA's suggestions, the criteria for preferential risk weight treatment should include the following four criteria: (i) requirements for eligible cover assets; (ii) limits on substitution assets; (iii) LTV limits for mortgage cover pools; and (iv) minimum effective overcollateralisation at the covered bond level.

The areas to be covered by the CRR requirements are summarised in Figure 40 below.

Figure 40: Areas covered in Step II (amendments to the CRR)

	Areas covered in Step II (amendments to the CRR)	rule – not covered by current EU legislation; extension/amendment of the existing rule)		
Conditions for preferential risk weight treatment				
1.	Requirements for eligible cover assets	Extension/amendment of the existing rule (CRR – Art. 129(1))		
m.	Limits on substitution assets	New rule		
n.	LTV limits for mortgage cover assets	Extension/amendment of the existing rule (CRR – Art. 129(1))		
0.	Minimum overcollateralisation	New rule		



Step III - Voluntary convergence of national covered bond frameworks

Rationale

In the context of Step III of the suggested approach to harmonisation, further convergence between national frameworks should be encouraged on a voluntary basis in areas that are considered to have less material impact on safeguarding the quality of the covered bond product, and/or where convergence is seen as beneficial but harmonisation by means of a binding legal instrument could potentially have an unintended disruptive effect on the good functioning of national markets.

Areas covered

The areas covered by the third step should include the following:

Figure 41: Areas covered in Step III (voluntary convergence)

,	Areas covered in Step III (voluntary convergence)	Relation to the current regulatory treatment (new rule – not covered by current EU legislation; extension/amendment of the existing rule)
p.	Composition of the cover pools	New rule
q.	Cover pool with underlying assets/obligors located in juris dictions outside the EEA	New rule
r.	LTV measurement and frequency of revaluation	Extension/amendment of the existing rule (CRR – Art. 208 and Art. 229(1) via Art. 129(3))
S.	Stress testing by the covered bond issuer	New rule



Figure 42: The EBA recommendation on three-step harmonisation of covered bond frameworks in the EU

STEP I:

Development of a covered bond framework (directive)

Esta blishment of the base-line definition of the covered bond for EU financial regulation

Replacement of the covered bond-related provisions in UCITS Directive

Focus on structural features

Point of reference for prudential regulatory purposes (e.g. BRRD, LCR)

Applicable across sectors

Requirements in Step I obligatory for all covered bonds seeking regulatory recognition

Areas covered:

- 1. Dual recourse, segregation of cover assets and bankruptcy remoteness of the covered bonds
- 2. Requirements for coverage, liquidity risk mitigation and cover pool derivatives
- 3. Requirements for the system of special public supervision and administration:
- (i) Cover pool monitor
- (ii) Supervision of covered bond issuer
- (iii) Supervision in the event of issuer's insolvency/resolution
- (iv) Administration postissuer's insolvency/resolution
- 4. Transparency requirements
- 5. Conditions for soft bullet and CPT covered bond structures

STEP II:

Amendments to the CRR (related to preferential risk weight treatment)

Enhanced conditions for preferential risk weight treatment

Focus on credit risk related features

Requirements in Step I as well as Step II obligatory for all covered bonds seeking preferential risk weight treatment

Areas covered:

All requirements in STEP 1

+

- 1. Requirement for eligible cover assets
- 2. Limits on substitution assets
- 3. LTV limits for mortgage cover assets
- 4. Minimum overcollateralisation

STEP III: Voluntary convergence

Voluntary convergence of national frame works through non-binding instruments

Specific a reas with less material impact on the overall robustness of the covered bond frame works

Areas covered:

- 1. Composition of the cover pools
- 2. Cover pools with underlying assets/obligors located in jurisdictions outside the EEA
- 3. LTV measurement and frequency of revaluation
- 4. Stress testing by the covered bond issuer



3.4 Step I – Development of a covered bond framework

Dual recourse, segregation of cover assets and bankruptcy remoteness of covered bonds

Dual recourse

The dual recourse mechanism is a defining concept and an essential element of the covered bond product. Reproducing what is currently specified in the UCITS, the covered bond framework should specify that the covered bond must grant the investor: (i) a claim on the covered bond <u>issuer</u>, limited to the complete fulfilment of the payment obligations attached to the covered bond; and (ii) in case of the issuer's insolvency, a priority daim on the <u>proceeds from assets</u> included in the cover pool, limited to the complete fulfilment of the payment obligations attached to the covered bond.

In addition to the establishment of the dual recourse principle, the covered bond framework should also clarify the nature of the daim to the insolvency estate of the covered bond issuer in case of deficiency of the cover pool—an aspect that is currently missing in the UCITS Directive. In what can be understood as an extension and further clarification of the recourse to the issuer, the framework should specify whether, should the assets included in the cover pool prove to be insufficient to fully meet the payment obligations towards the covered bond investor, the covered bond investor should be granted a claim on the covered bond issuer's insolvency estate, which should rank pari passu but not senior to the daims of the issuer's unsecured creditors. This is aimed at avoiding prudential concerns related to asset encumbrance, particularly in the case of universal credit institutions and other issuers with a substantial component of unsecured creditors.³⁴

The EBA recognises that the business of covered bond issuance has developed across different jurisdictions according to different models, as a result of a combination of historical and regulatory factors (universal credit institutions, specialised institutions, and credit institutions utilising SPVs). The EBA does not suggest harmonising the issuance model at the EU level, nor the model of segregation of the cover assets, as harmonisation in these areas is not considered decisive for establishing the dual recourse principle.

claim on the covered bond issuer's insolvency estate that ranks senior to the claim of the issuer's unsecured creditors.

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³⁴ However, in the case of non-deposit-taking specialised covered bond issuers—i.e. issuers whose business only or predominantly focuses on the issuance of covered bonds—and where financial payment obligations of the covered bond issuer exist exclusively vis-à-vis a parent institution or other member of the same consolidated group and therefore the issue of asset encumbrance is of less relevance, the covered bond investor could instead be granted a



b. Segregation of cover assets

The segregation of cover assets is a necessary component of the dual recourse mechanism, as only by an effective segregation of cover assets can the priority claim of the covered bond investor on the cover pool be ensured in the event of the issuer's insolvency or resolution. Similarly to dual recourse, it should therefore be regulated in the covered bond framework.

The element of segregation of cover assets, though well established in national covered bond frameworks, is not underpinned in the UCITS or in the CRR. The covered bond framework should therefore establish the following principles of segregation of cover assets:

- It should ensure identification at all times and effective legal segregation of all assets over which the investor has a priority daim (depending on the issuer model adopted at the national level) either by (i) registration of cover assets in a cover register, (ii) transfer of cover assets to a SPV or (iii) segregation in a specialised credit institution;
- It should ensure that the registration of cover assets in the cover register, the transfer of
 cover assets to a SPV and/or segregation in a specialised credit institution result in legally
 binding and enforceable arrangements, including in the event of the issuer's
 insolvency/resolution;
- It should ensure that the segregation arrangement includes all the cover assets contributing towards the coverage requirement, including (i) primary assets, (ii) substitution assets, (iii) liquid assets in the liquidity buffer, and (iv) cover pool derivatives entered into in order to hedge risks arising in the covered bond programme, including any collateral received in connection to the derivative positions. It should be clarified that the segregation arrangement includes not only cover assets contributing to required coverage, but also voluntary overcollateralisation i.e. cover assets set aside by the issuer for the benefit of the investors in addition to the required coverage.

c. Bankruptcy remoteness of covered bond

The remoteness (i.e. insulation) of covered bonds from the bankruptcy of the issuing entity is instrumental in especially allowing the full and timely repayment to the covered bond investor. It is directly linked to the dual recourse mechanism and, as such, its main principles should be regulated in the covered bond framework. Similar to the case of the segregation of cover assets, the requirement on bankruptcy remoteness of the covered bond, though well founded in national covered bond frameworks, is not underpinned in the UCITS or in the CRR.

The covered bond framework should introduce the following principles:

 The framework should prevent payment obligations attached to the covered bond automatically accelerating upon the issuer's insolvency/resolution, and hence ensure that the



options available to the covered bond administration to achieve full and timely repayment of the bonds are not constrained;

- It should require that, within the insolvency proceedings related to the issuer's insolvency, claims of covered bond investors and any other parties whose claim ranks at least pari passu with the claim of the covered bond investor (including counterparties to cover pool derivatives) are given priority with respect to proceeds from the assets registered in the cover pool and/or transferred to a special entity. Claims on the cover pool assets by the issuer's insolvency estate creditors (i.e. creditors other than the covered bond investors) should not be permitted, other than on a subordinated basis;
- It should require that the issuer has, at all times, a plan in place specifying the operational procedures aimed at ensuring a smooth transition to the special administration function and an orderly functioning of the covered bond programme upon insolvency/resolution of the issuer (later referred to as 'operational plan').

Taking into account the wide variety of rules on operational aspects of bankruptcy remoteness in national covered bond frameworks, the covered bond framework should specify (in more detail) the operational requirements that the issuer should have in place and that should be detailed in the operational plan. The operational requirements should, as a minimum, include the following aspects (unless they are already covered in the issuer's resolution and insolvency proceedings, in which case they should refer to these existing proceedings):

- Identification of staff and framework required for conducting the covered bond business —
 Staff of the covered bond issuer that is core for the continuity of the administration of the
 covered bond programme should be identified, as well as their respective tasks and duties. In
 addition, the existing written framework for conducting the covered bond business should be
 identified;
- Documentation identification All relevant underlying documentation related to the cover pool, both in a physical and electronic form, should be duly segregated and readily available for access by the special administrator. This includes, inter alia, the cover register and the documentation regarding cover pool derivatives. Other ancillary services attached to the covered bond programme should also be duly documented and mapped in a segregated fashion;
- IT infrastructure and data identification All relevant underlying data that is necessary to carry out coverage calculations, as well as necessary IT infrastructure, should be duly identified in the IT system of the issuer and readily available for access by the special administrator;
- Estimate of costs of the special administration An estimate of the first year and, as appropriate, overall costs involved in the special administration function should be calculated on a best-efforts basis and expressed as a percentage of cover assets under management.



The operational plan should (i) specify the operational procedures in a manner that is comprehensive and, at the same time, easily understandable by external parties; (ii) be kept with the covered bond issuer; (iii) be made readily available and accessible to the special administrator from the beginning of his appointment; (iv) be updated by the issuer upon changes to the operational procedures; and (v) be reviewed for adequacy by the issuer, at least annually.

Requirements on coverage, liquidity risk mitigation and cover pool derivatives

d. Coverage requirements

Artide 52(4) of the UCITS Directive establishes the coverage principle of covered bonds—another defining core element of the covered bond—requiring that, during the whole period of the bonds' validity, the assets underlying the covered bonds must be capable of covering daims attached to the bonds. The EBA suggests going beyond the current UCITS general reference to the coverage principle and suggests introducing requirements with regard to the scope of the cover assets—i.e. assets contributing towards the coverage requirement, the scope of liabilities to be covered by the cover assets for the purpose of the coverage requirement, and regarding the calculation of coverage. More concretely, the covered bond framework should establish the following:

Principle of the coverage:

• The cover assets should be capable, during the whole period of validity of the covered bonds, to cover all the liabilities attached to these bonds. This principle translates into a requirement that the sum of all payment claims on the cover assets (including primary assets, substitution assets, liquid assets and cover pool derivatives) has, at all times, to be at least equal to the sum of all payment obligations attached to the corresponding covered bonds (including associated operational costs).

Scope of the cover assets (i.e. assets contributing towards the coverage requirement) should include:

- Claims for payments of the principal of primary assets, substitution assets and liquid assets held in consequence of a liquidity buffer;
- The aggregate amount of claims for payments of the interest of primary assets, substitution
 assets and liquid assets for the remaining maturity of the assets, based on amortisation
 schedules applicable at the time of assessment. In the case of variable interest rates, these
 should be fixed as at the time of assessment;
- The cover pool derivatives contribute to the coverage requirement on the asset side, either by a positive or a negative value, as follows:



- o the cash inflows and the cash outflows for all derivative transactions conduded under a master agreement are summed up into one aggregate cash flow amount³⁵;
- o the aggregate cash flow amount of all derivative transactions in the master agreement is compared with the close-out amount of that master agreement;³⁶
- o the smaller amount of the two³⁷ determines the contribution of the cover pool derivatives towards the coverage requirement as either a positive or negative cover asset. The approach of considering a dose-out amount in the calculation of contribution of the cover pool derivatives to the coverage reflects the fact that in contrast to a typical cover asset, cover pool derivatives concluded under a master agreement are subject to an additional layer of claims or obligations contingent on the default of a counterparty, which is beyond the control of the covered bond issuer.
- Uncollateralised claims from defaulted exposures in accordance with Article 178 of the CRR—
 i.e. uncollateralised claims from credit obligations to obligors that are considered unlikely to
 pay their credit obligations to the issuer in full without recourse to actions such as realising
 security, and to obligors that are at least 90 days past due on any material credit obligation to
 the issuer—should not be counted to fulfil any of the coverage requirements (i.e. neither the
 general nor the liquidity coverage requirement).

Scope of liabilities that should be covered by the cover assets for the purposes of the coverage requirement should include:

- Obligations for the payment of the principal of outstanding covered bonds;
- The aggregate amount of obligations for the payment of interest for the remaining maturity of
 the outstanding covered bonds, based on amortisation schedules applicable at the time of
 assessment. In the case of variable interest rates, these should be fixed as at the time of
 assessment;

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³⁵ The cash inflows and outflows for each derivative transaction are converted at spot prices to the extent not expressed in the covered bond programme's currency or are based on variables. Inflows carry positive prefixes, outflows negative ones. The master a greement under which the cover pool derivative transactions are concluded should be a market standard agreement, enforceable in all jurisdictions relevant to the cover pool derivative transactions, and it should only include derivative transactions related to one covered bond programme.

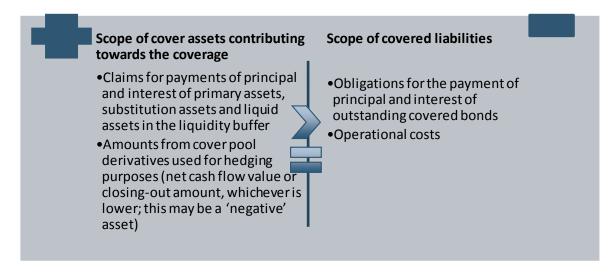
³⁶ This a mount takes into a ccount received collateral only, if segregated for the benefit of the covered bondholders. It disregards provided non-cover asset collateral.

³⁷ I.e. the smaller amount if both are positive, the negative amount if one is positive and the other negative, or the more negative amount if both are negative



 Operational costs related to maintenance and administration of the covered bond programme, at least to the extent such expense-related liabilitites are current.

Figure 43: Cover assets and liabilities included in the scope of the coverage requirement



Calculation of the coverage:

- The calculation of principal should be based on a nominal principle.³⁹ The calculation of interest and derivatives should follow the approach specified in points above respectively. All future payments (daims as well as obligations) should be undiscounted and variable future payments should be taken at the current spot rates.
- Other forms of calculation of coverage (i.e. net present value, net present value under stress, prudent market value) should be allowed as long as they result in a level of coverage that is not lower than the coverage based on the calculation in this section;
- The extent of the contribution of cover assets to coverage should be calculated taking into consideration the restrictions applicable under quantitative requirements. In particular, this should include the (soft) LTV limits that should be applied to loans secured by immovable property on an ongoing basis—i.e. only the portion of the loans that does not exceed the LTV limits should contribute to the coverage requirement. This requirement should be met on an ongoing basis throughout the life of the covered bond programme.

This should not prevent the national frameworks from introducing hard LTV limits in addition to soft LTV limits, as long as the hard LTV limits are only applied at the inclusion of the loan in the cover pool (i.e. only the loans in compliance with the hard LTV limits are eligible for inclusion in the cover pool), and are not applied during the life of the covered bond

The operation costs include, for example, liabilities towards managers/administrators, servicers, trustees, cover pool monitors and similar entities involved in the process of the covered bond issuance.

³⁹ The coverage principle takes different forms a cross different jurisdictions (nominal coverage, net present value coverage, net present value coverage, net present value coverage under stress, and prudent market value coverage); however, nominal coverage is used in a significant majority of jurisdictions.



programme. Taking into account the coverage disruptions that may be caused by the ongoing application of hard LTV limits - such as in case of severe declines of real estate prices - only soft LTV limits and no hard LTV limits should be applied on an ongoing basis.

Establishment of the minimum level of coverage that would be required for the covered bond to be eligible for preferential risk weight treatment (i.e. the overcollateralisation requirement) should be treated under Step II (i.e. in the CRR).

e. Liquidity risk mitigation requirements

Addressing liquidity risk is crucial for ensuring timely repayment of liabilities attached to the covered bond. There is currently no requirement in EU regulation to have a liquidity buffer in place for the purpose of addressing the liquidity risks associated with the repayment of covered bonds, from within the programmes.

The covered bond framework should therefore introduce such a requirement. The main objective for this liquidity buffer would be to address, in a comprehensive manner, various different possible factors behind the occurrence of a liquidity shortage, such as mismatches in maturities and interest rates, payment interruptions, commingling risks and derivative and other operational liabilities falling due.

The liquidity buffer should be composed of liquid assets (in line with the composition requirements below) whose value is able to cover, as a minimum, the net liquidity outflows of the covered bond programme over the next 180 days, i.e. all liabilities (including principal and interest payments and payments under derivatives, as specified below) of the respective covered bond programme over the next 180 days on a net basis.

Importantly, as the liquidity risk in relation to the covered bond increases, particularly in the case of an issuer's insolvency/resolution, the liquidity buffer should be distinguished from the already existing prudential regulation on liquidity (particularly the LCR requirement). The existing LCR requirements apply to covered bond issuers, while the covered bond liquidity buffer particularly targets the scenario of an issuer's insolvency (where the liquidity safeguards of the issuer are no longer available) and is thus designed for further protection of the covered bond investor.

The liquid assets held for the purposes of the covered bond liquidity buffer should therefore be segregated and should be held separately from other cover assets of the covered bond programme, within the cover pool.

Taking into account the above, the covered bond framework should establish the following:



Requirement to hold the liquidity buffer:

• The issuer should be required to hold liquid assets (subject to the requirements below) available at all times to cover the net liquidity outflows of the covered bond programme. The requirement should apply at all times as long as the issuer is going concern. 40

Size of the liquidity buffer:

• The value of the liquid assets should, as a minimum, cover all principal and interest payments of the respective covered bond programme, and cash flows payments on cover pool derivatives transactions⁴¹, over the next 180 days on a net basis (i.e. all outflows coming due over the next 180 days after considering expected inflows over the same period).

Treatment of soft bullet and CPT covered bonds:

 In case the covered bond programmes allow for soft bullet and/or CPT covered bonds (for which the payment date of the principal can be postponed and extended beyond the scheduled maturity date), the calculation of principal for the purposes of the liquidity buffer may be based on the final maturity date of the covered bonds.

Composition of the liquidity buffer/requirements on eligibility of assets for the liquidity buffer:

- The assets eligible for the purposes of the liquidity buffer should include:
 - O The assets eligible as Level 1 and Level 2A assets under the LCR requirements specified in the LCR Delegated Act, excluding own-issued covered bonds; and
 - o Exposures to institutions as currently regulated in Artide 129(1)(c) of the CRR, including exposures in the form of cash deposits. These exposure should be subject to the same percentage limits as applicable under current CRR (i.e. 15%/10%). It should be clarified however that these apply in relation to the minimum required coverage ⁴². These limits should not apply to any exceeding voluntary coverage;
- In case the liquidity buffer consists of cash deposits, the bank account provider should be subject to strict and enforceable replacement triggers (based on the rating). In case the liquidity buffer consists of securities, it should be held in a segregated (i.e. bankruptcy remote) account.

Valuation of liquid assets for liquidity buffer purposes:

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 $^{^{40}}$ For a voi dance of doubt, this requirement only relates to the covered bond framework, and is without prejudice to the LCR rules.

⁴¹ For cover pool derivatives, the cash flow profile of the individual transaction (rather than the close-out amount) should be considered.

⁴² And hence not the amount of outstanding covered bonds, as currently applicable.



Valuation of liquidity buffer assets should be based on market value in accordance with the
applicable accounting framework, and subject to specific market based haircuts (such as
central bank haircuts).

Clarification of the position of the liquidity buffer in relation to coverage requirements and segregation arrangements:

- Liquid assets held in consequence of a liquidity buffer may contribute towards the general coverage requirement⁴³;
- Uncollateralised claims from defaulted exposures in accordance with Article 178 of the CRR—
 i.e. uncollateralised claims from credit obligations of obligors that are considered unlikely to
 pay their credit obligations to the issuer in full without recourse to actions such as realising
 security, and to obligors that are at least 90 days past due on any material credit obligation to
 the issuer—should not contribute towards fulfilling any of the coverage requirements;
- Liquid assets should be part of segregation arrangements.

Exceptions from the requirement to hold a liquidity buffer:

 A liquidity buffer is not considered necessary for some specific match-funded structures of covered bonds, where liquidity risk is eliminated by matching cash flows between the liabilities falling due and assets falling due and hence also between payments from the borrowers and the payments due to covered bond investors.

Interactions with the existing prudential liquidity requirements (LCR):

- Some interactions of the covered bond liquidity buffer, including cash inflows on cover assets, with the LCR requirement are proposed, with respect to the covered bond related outflows in the LCR, in a way not weakening the current LCR requirements.
- It could be further explored to establish that the liquid assets in the liquidity buffer (including cash inflows on cover assets) should in principle, not count towards the LCR to be maintained by the issuer in accordance with the LCR Delegated Act. However, with the aim to avoid potential 'double' liquidity requirements for the issuer, it could be further explored to establish that the liquid assets within the liquidity buffer that are compliant with the LCR eligibility criteria, haircuts and other LCR requirements—while always held separately within the covered bond programme and always segregated from the liquid assets held for the purposes of the LCR—should be allowed to cover outflows related to that covered bond programme over the next 30 days under the LCR. In other words, the outflows under LCR related to the covered bond programme could be covered by the liquid assets segregated in the covered bond liquidity buffer.

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⁴³ It is to be clarified that liquid assets contribute to the coverage in line with the coverage requirements specified in the section 'd' of this chapter (i.e. at the value as specified in that section and without applying haircuts).



- In case these would prove insufficient to cover the respective outflows over the next 30 days, taking into account that the LCR are subject to different and in many instances stricter requirements, the remaining covered bond outflows would be covered by other liquid assets held in accordance with the LCR (in this context it is to be noted that proposed composition, eligibility, size, haircut and other requirements on the liquid assets in the covered bond liquidity buffer differ from those applicable to liquid assets under the LCR, with LCR requirements being generally stricter and including additional requirements (such as caps) while covering a shorter liquidity time window (30 days compared to 180 days for the covered bond liquidity buffer).
- The implementation of the proposal would possibly require a change to the LCR Delegated Act, concretely to the Article 8 which requires the liquid assets for the purposes of the LCR to be held unencumbered (i.e. to be readily accessible and not subject to legal or practical impediments so as to allow them be monetised in a timely fashion). It could be further explored to amend the Artide to clarify that the liquid assets segregated in the covered bond liquidity buffer are not considered as encumbered, subject to some specific conditions. 44

Impact assessment:

- It is recommended that an impact assessment is conducted to assess in particular: (i) the implications of the proposed interactions of the liquidity buffer with the LCR, including the proposal to waive the requirement in the LCR Delegated Act on unencumbrance for the liquid assets in the cover pool, and interactions with the international prudential liquidity standards; (ii) functioning of the liquidity buffer in a resolution situation, and the interactions with the BRRD; and (iii) scope of assets eligible for the purposes of the liquidity buffer and possibility of an expansion to a wider set/other liquid assets.
- It is also recommended to assess whether the proposed requirements may possibly encourage a more extensive use of some specific types of amortisation structures of the covered bonds (soft bullets and CPTs), and whether this may lead to some unintended consequences. The assessment should also include the market impact if the calculation of the liquidity buffer is based on the scheduled maturity date of the covered bond instead of the (extended) final maturity date.

f. Requirements on cover pool derivatives

segregated (and hence encumbered) in the cover pool.

Interest rate and foreign currency risks should be appropriately mitigated at all times. Different mitigation tools can be used for this purpose, including a reflection of market risk stress testing in coverage requirements, overcollateralisation, and the use of cover pool derivatives as part of the

 $^{^{44} \ \}text{I.e.\,it} \ \text{is} \ \text{re} \ \text{commended} \ \text{to} \ \text{waive} \ \text{the} \ \text{re} \ \text{quirement} \ \text{on} \ \text{unencumbrance} \ \text{for} \ \text{this} \ \text{s} \ \text{pecific} \ \text{case, subject to} \ \text{s} \ \text{ome} \ \text{specific} \ \text{case}, \ \text{subject to} \ \text{s} \ \text{ome} \ \text{specific} \ \text{case, subject to} \ \text{s} \ \text{ome} \ \text{specific} \ \text{case, subject to} \ \text{s} \ \text{ome} \ \text{specific} \ \text{case, subject to} \ \text{s} \ \text{ome} \ \text{specific} \ \text{ome} \ \text{s} \ \text{ome} \ \text{s} \ \text{ome} \ \text{s} \ \text{ome} \ \text{s} \ \text{ome} \ \text{ome} \ \text{s} \ \text{ome} \ \text{s} \ \text{ome} \ \text{s} \ \text{ome} \ \text{s} \ \text{ome} \ \text{ome}$ conditions, and to allow that outflows related to the covered bonds under the LCR can be covered by liquid assets



asset and liquidity management of the covered bond programme. The UCITS Directive and the CRR are silent on the use of derivatives in the context of the covered bond programmes. The EBA suggests specifying, in the covered bond framework, such general requirements on cover pool derivatives allowed as part of covered bond programmes, aiming at preventing the use of derivatives in speculative transactions and introducing some general quality requirements on such derivative contracts.

The covered bond framework should establish the following requirements:

- Derivative contracts entered into by the covered bond issuer with a derivative counterparty should be allowed—as part of covered bond programmes— exclusively for risk hedging purposes and they should be documented according to standard industry master agreements;
- Derivative contracts should be part of the cover pool and cannot be terminated upon the issuer's insolvency (failure to pay under the derivative contract should remain a valid termination event);
- The covered bond framework should specify the eligibility criteria for the hedging counterparties—e.g. by limiting the eligible counterparties to credit institutions, investment firms, insurance/reinsurance undertakings, financial services institutions, CCPs at a stock exchange, and public bodies⁴⁵;
- It should require that, in the event of the loss of sufficient creditworthiness of the counterparty, the counterparty is subject to collateralisation requirements and/or should make reasonable effort to arrange for its replacement by another counterparty;
- It should clarify the treatment of cover pool derivatives in relation to coverage and segregation arrangements. Concretely, it should be required that cover pool derivatives are contributing towards the coverage requirement. Also, it should be required that the cover pool derivatives, as well as any collateral received in connection to the derivative positions, are included in the segregation arrangements.

System of special public supervision and administration

Special public supervision of the covered bonds, designed to protect bondholders, is another core feature of the covered bond instrument and is also anchored in the UCITS Directive (Artide 52(4)) as one of the main defining core elements of the covered bond. However, apart from establishing

⁴⁵ Such as central governments and other public sector entities of EU Member States, central banks of EU Member States, ECB, International Monetary Fund, European Investment Bank, Bank for International Settlements, and multilateral development banks



the principle of special public supervision, the UCITS Directive does not elaborate further on requirements substantiating the 'special' and/or 'public' aspects of the supervision. The system of special public supervision should therefore be substantiated in a covered bond framework, and should set out the requirements in the following areas with the overall objective of protecting covered bond investors and ensuring proper functioning of the covered bond programme: (i) competences of the cover pool monitor; (ii) supervision of the covered bond issuer in going concern; and (iii) supervision and duties and powers of the competent authority in the event of the issuer's insolvency/resolution.

Furthermore, the covered bond framework should establish the role of the special administrator in the phase following the issuer's insolvency/resolution (currently not specified in the UCITS nor in the CRR). This administrator would take on a key role in fulfilling all due obligations attached to the covered bond programme, in order to operationally strengthen the preferential claim of the covered bond investors and to avoid conflicts of interest with the issuer's insolvency administrator.

g. Cover pool monitor

The establishment of the cover pool monitor should be regulated in the covered bond framework as a standard requirement for the covered bond product and an essential pillar of the special public supervision of covered bonds. Although well established in national covered bond legislations, the requirement for a cover pool monitor is not specified in EU legislation.

The covered bond framework should establish rules on the following:

- Appointment of a cover pool monitor at the establishment of a covered bond programme, and dismissal of the cover pool monitor. The competent authority should play decisive role in this⁴⁶;
- Eligibility criteria, including independence and qualification requirements for the cover pool monitor;

Furthermore, the covered bond framework should specify the cover pool monitor's main duties and powers. As a minimum, these should include the following:

- Duty of ongoing and regular monitoring of covered bonds' compliance with the requirements of covered bond legislation, including requirements related to the eligibility of cover assets, coverage, liquidity, cover pool derivatives and transparency;
- Duty of reporting vis-à-vis the competent authority:

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 $^{^{46}}$ E.g. the cover pool monitor is appointed by the competent a uthority or by the issuer with the approval of competent a uthority



- Regular, at least annual, reporting on compliance with the relevant requirements in the covered bond legislation;
- Reporting on material observations regarding the covered bond business, including in cases when assets are added/removed to the cover pool and cause substantial change in the coverage requirements;
- o Duty to respond to information requests and inquiries from the competent authority.
- With regard to the powers, the cover pool monitor should be granted access by the issuer to the information needed for the performance of his tasks.

The covered bond framework should allow the function of the cover pool monitor to be suspended upon the establishment of a special administrator (e.g. in case its function is no longer considered necessary due to the special administrator taking over the tasks).

In addition, the framework should clarify that, where similar tasks are directly carried out by the competent authority, the appointment of a cover pool monitor may not be necessary. However, with the aim to ensure its independence, the cover pool monitor should always be a person separate from the issuer and the issuer's ordinary auditor. An internal entity to the covered bond issuer should not be allowed to act as the cover pool monitor.

h. Supervision of the covered bond issuer

As another key constituent of special public supervision, the covered bond framework should require that the issuers and the covered bond programmes be subject to special and explicitly determined supervisory rules and requirements by a competent authority, which go beyond the regular (prudential) banking supervision. The current EU regulation does not stipulate such explicit supervisory rules with respect to covered bond programmes, apart from establishing the general principle of special public supervision in the UCITS Directive. The EBA has observed that there is a significantly high level of divergence in the way in which the national covered bond frameworks stipulate such supervisory requirements with respect to covered bond programmes. The EBA considers it paramount to substantiate special public supervision, as it is a core pillar of a sound and robust covered bond framework.

Special public supervision can either be exercised by a separate authority or by the same authority that is responsible for the general prudential supervision of credit institutions in the specific jurisdiction (provided that such tasks can be conferred to the authority in charge of the prudential supervision). In either case, the competent authority should supervise the covered bond issuer according to special supervisory rules, and should regularly monitor the issuer's fitness to comply with all the applicable requirements attached to the granting of the approval of/licence for the covered bond programme and to all other relevant requirements of the covered bond legislation.



The covered bond framework should require that national covered bond frameworks clearly specify (i) the competences of the competent authority vis-à-vis the issuer; (ii) the tasks and duties of the issuer vis-à-vis the competent authority, and (iii) the distribution of tasks and competences and communication/reporting obligations between the competent authority, resolution authority, cover pool monitor and special administrator.

Furthermore, the covered bond framework should provide an overview of the minimum set of competences of the competent authority vis-à-vis the issuer, and the tasks and duties of the issuer vis-à-vis the competent authority as follows.

Competences of the competent authority:

- The competent authority should at least approve (or license) the establishment, by a given issuer, of a covered bond programme. The establishment of new covered bond programmes should be subject to a separate (ex ante) approval/licence. Furthermore, issuances within the approved/licensed covered bond programmes should be subject to (ex post) notification to the competent authority (either subject to individual notification for each issuance or regular notifications on issuances on an aggregated basis), and should include information on the main features of all the outstanding issues within that programme (such as on nominal value, specific composition of the cover pool, maturity, and compliance with all other prudential requirements);
- As part of the approval/licensing procedure, and prior to the first issuance in the covered bond programme, the competent authority should be satisfied (at least on the basis of information received from the issuer) that: (i) adequate operational policies, procedures, controls and plans are put in place by the issuer for the management of the covered bond programme, including for the transition to and during the issuer's insolvency or resolution; (ii) the management and staff of the issuer have adequate qualifications and experience/knowledge in the area of the covered bond business; (iii) where provided by the national framework, the restrictions applicable to the issuer are met; and (iv) the features of the cover pool meet the applicable requirements;
- With regard to specialised credit institutions, the EBA acknowledges that the supervisory practice of licensing such specialised covered bond issuers (which only carry out covered bonds issuance activity and related ancillary activities) may ensure a level of supervision of the issuer that is comparable to the one achieved by the approval/license of new covered bond programmes. Only in the case of specialised and duly licensed covered bond issuers, the establishment of new covered bond programmes does not need to be subject to individual approval/licence; however, as a minimum, each covered bond programme should be subject to ex ante notifications to the competent authority. All the other above requirements (i.e. on aspects considered by competent authorities when attributing a licence to the specialised credit institutions, and on notifications of issuances within the programmes) remain the same;



- The competent authority should have the right to execute on-site inspections and request provisions for further documentation and information by the issuer as part of the approval/licensing process;
- The competent authority should have a wide range of prompt corrective/ enforcement/ intervention powers to ensure that issuers comply with the requirements, including: enhanced reporting requirements; enhanced on-site and off-site inspection powers; imposition of fines and penalties; and withdrawal of approval/licence for the covered bond programme/specialised covered bond issuer;
- If the cover pool monitor is an entity separate from the competent authority, the competent authority should have a decisive role in its appointment and dismissal.

Tasks and duties of the issuer vis-à-vis the competent authority (in addition to those described above):

• The issuer should be required to report to the competent authority—on a regular basis and at the request of the competent authority—according to special reporting rules relating to covered bond programmes and separate from the regular banking reporting. The issuer should be required to notify the competent authority about changes in the features of the covered bond programme, including: (i) in case the covered bond issuance is undertaken in markets new to the issuer; (ii) in the case of the transfer of all cover assets' ownership in tandem with the covered bond obligations.

The EBA is aware of the issue of asset encumbrance raised as a consequence of the use of covered bonds and resulting in a structural subordination of unsecured creditors and deposit holders. It is understood this is a wider regulatory and supervisory issue that needs to be explored in depth, and that extends beyond the scope of this report and beyond the remit of the special public supervision.

i. Supervision in the event of the issuer's insolvency/resolution

The covered bond framework should provide a sufficiently detailed description of the duties and powers of the competent authority for the covered bond programme—as well as administration of the covered bond programme—in the event of the issuer's insolvency/resolution, as this is considered another core pillar of special public supervision. Again, in the absence of specific requirements in the EU legislation in this area, most jurisdictions seem to provide for the competent authorities' duties and powers in their national legislations; the extent of such provisions, however, varies from one jurisdiction to another.

The covered bond framework should therefore require that the competent authority, as a minimum:



- Has a decisive role in the appointment and dismissal of the covered bond administrator;
- Approves the transfer of the cover assets in tandem with covered bond obligations to other covered bond issuers in the event of the issuer's insolvency/resolution.

The covered bond framework should also require coordination and exchange of information between the competent authority, the special administrator and the resolution authority in the event of the issuer's insolvency/resolution.

As a minimum, the resolution authorities should ex ante notify the competent authority and the special administrator of any decision impacting covered bonds, including the application of a bail-in instrument to the covered bonds, partial transfers and filing for bankruptcy of a covered bond bridge bank upon non-extension of the bridge bank term.

In the case of the issuer's resolution, the tasks conferred on the competent authority should be without prejudice of those tasks conferred on the resolution authority by the relevant EU law provisions, and particularly the BRRD.

The EBA's general understanding is that the resolution authority would exercise its role and responsibilities particularly in relation to resolution tools, while the competent authority would do so notably in relation to the managing of covered bond programmes during insolvency or similarly related processes. The interaction between, and discharge of, the duties of the resolution authority and competent authority in the resolution/insolvency phase remains an untested area; henceforth, the EBA considers that this requires further consideration.

j. Administration of the covered bond programme post the issuer's insolvency/resolution

Taking into account the absence of a requirement in EU legislation on the special administration of covered bond programmes following the issuer's insolvency/resolution, the covered bond framework should establish the following principles:

- It should require that, upon the issuer's insolvency or resolution, the covered bond programme is managed in an independent manner and in the preferential interest of the covered bond investor;
- It should provide for clear and sufficiently detailed provisions on the duties and powers of the special administration function so as to ensure that the special administrator can take all action that may be necessary for the full realisation of the interests of the covered bond creditor. It should also maintain a high level of legal clarity and transparency vis-à-vis the investor for covered bond management in scenarios of potential distress (such as the issuer's insolvency or resolution).



• In particular, the framework should ensure that the powers of the administration function with respect to the covered bond business are discharged in a manner that is cognisant of any broader resolution or insolvency process affecting affiliates of the issuer (e.g. a parent entity).

Furthermore, the covered bond framework should elaborate (in more detail) on the above principle, and should establish rules on the following:

- Appointment of the special administrator (either by an insolvency court, a competent authority or another public authority), and dismissal of the special administrator. The competent authority should play a decisive role in this.
- Obligation to interact (including communication, consultation, exchange of
 information and reporting) with the competent authority, resolution authority and—
 in cases where the special administration is executed by an entity independent from
 the insolvency court—with the insolvency court. The special administrator should not
 be restricted by law to do so;
- Objectives, duties and powers of the administration function, including, as a minimum:
- Objective to complete the fulfilment of liabilities attached to the covered bond, and to manage the covered bond programme in the best interests of covered bond investors;
- With the prior approval of bondholders when necessary, power to manage and dispose of cover assets, including the right to transfer cover assets in tandem with covered bond obligations to another issuer (the latter should be subject to approval by the competent authority);
- With the prior approval of bondholders when necessary, power to carry out legal transactions with respect to the issuer necessary for the proper administration of the cover pool (such as procuring liquid funds to ensure timely repayment of outstanding covered bonds);
- Duty to transfer cover assets remaining after the meeting of all covered bond liabilities to the issuer's insolvency estate, in cases where the cover assets are held in a legal entity separate from the issuer;
- Duty to monitor, on an ongoing basis, coverage of liabilities incurred and recoverability of the cover pool.

These are without prejudice to any relevant actions that may be taken by the resolution authority (such as actions in instances when the cover pool is undercollateralised, in which 'complete fulfilment of liabilities' and managing the covered bond programme in the 'best interests of covered bond investors' may be in conflict with a resolution authorities' preference to bail-in the covered bonds as long as permitted under the BRRD).



The EBA does not suggest harmonising which entity or person should be appointed to deal with the scenario post an issuer's insolvency (i.e. separate independent entity or the insolvency court). As long as the independence of the special administrator is ensured, the decision should be left to individual jurisdictions.

Transparency requirements

k. Scope, format and frequency of disclosure

The current CRR already establishes the disclosure requirements that are necessary to be fulfilled in case the investor in the covered bond seeks preferential risk weight treatment. However, no harmonised legislative rules currently exist at the EU level that set out minimum standard disdosure rules for all covered bonds (i.e. not only for those seeking preferential treatment). Disclosure requirements applicable to all regulated covered bonds should therefore be harmonised in the covered bond framework, so as to enhance comparability, transparency and market stability by helping investors better understand the profile and risks of a programme and to undertake their due diligence.

When developing the disclosure requirements, it should be considered to what extent the existing market-based initiatives—particularly the ECBC's HTT, the ICMA transparency templates and the relevant national initiatives—should be taken into account and reflected in the disdosure requirements. In particular, the following could be considered regarding the scope, format and frequency of the disclosure:

Scope:

- The covered bond issuers should be required 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 required coverage, contractual and voluntary overcollateralisation;
- The information to be disclosed should also include: (i) information on the structure of the covered bond and any material changes thereto (e.g. on hard bullet, soft bullet, CPT and match-funded structures); and (ii) for covered bonds collateralised by mortgages, methodology⁴⁷ used by the issuer for calculating the value of property and LTV (e.g. market value).48

 $^{\rm 47}$ Its hould be noted that this is covered in Step III and subject to voluntary convergence.

 $^{^{48} \, \}text{Takinginto account the obligatory introduction of the LTI ratio by the Mortgage Credit Directive (2014/17/EU), it are the contraction of the LTI ratio by the Mortgage Credit Directive (2014/17/EU), it are the contraction of the LTI ratio by the Mortgage Credit Directive (2014/17/EU), it are the contraction of the LTI ratio by the Mortgage Credit Directive (2014/17/EU), it are the contraction of the LTI ratio by the Mortgage Credit Directive (2014/17/EU), it are the contraction of the LTI ratio by the Mortgage Credit Directive (2014/17/EU), it are the contraction of the LTI ratio by the Mortgage Credit Directive (2014/17/EU), it are the contraction of the LTI ratio by the Mortgage Credit Directive (2014/17/EU), it are the contraction of the LTI ratio by the Mortgage Credit Directive (2014/17/EU), it are the contraction of the LTI ratio by the Credit Directive (2014/17/EU), are the contraction of the LTI ratio by the Credit Directive (2014/17/EU), and the contraction of the Credit Directive (2014/17/EU), are the contraction of the Credit Directive (2014/17/EU), and the Credit Directive (2014/17/EU), and the contraction of the Credit Directive (2014/17/EU), and the contraction of the Credit Directive (2014/17/EU). The contraction of the Credit Directive (2014/17/EU) (2014/17/EU), and the Credit Directive (2014/17/EU), a$ could be considered to also require a disclosure of loan-to-income (LTI) information.



- Issuers should also be required to publish all transaction documents (excluding legal opinions)
 relating to covered bond programmes, including the publication of any amended documents,
 e.g. in case of changes to the voting rights (or, alternatively, to disclose information where the
 relevant published documents can be consulted);
- Specific/additional information should be disclosed for different types of cover pools, with
 different information required for mortgage assets (e.g. LTV ratios), public sector assets (e.g.
 type of public borrower) and other types of assets. Differentiation should also be made
 between residential and commercial types of mortgages (e.g. loan purpose and credit
 characteristics of the debtor for residential mortgages, and distribution by sector for
 commercial mortgages);
- The disdosure requirements should include a statement from the issuer as to whether it is compliant with the regulatory criteria (at a minimum, with the CRR and the LCR requirements). It should be taken into account that such statements should not replace the due diligence by investors or compliance with the CRR and the LCR requirements;
- In addition, a glossary should be part of such disclosure requirements, where an issuer would provide definitions and criteria used in the disclosure template (e.g. on the methodology for the calculation of coverage requirements and property valuations);
- The information should be disclosed to a level of detail that enables investors to carry out a comprehensive risk analysis. Aggregate level disclosure, rather than loan-by-loan level disclosure (currently in place in one jurisdiction only), is generally deemed sufficient in this regard. The level of detail of disclosure should take into account relevant factors such as amortisation profile of the covered bond and type of underlying assets. For covered bonds allowing long maturity extensions (such as CPTs), a higher level of disclosure may be more appropriate.

Format:

 The information should be accessible in a standardised format and from a common point of access;

Frequency:

• With regard to frequency, disclosure should occur at least on a quarterly basis (it should be noted that the CRR currently requires disclosure on at a least semi-annual basis). Disclosure on a quarterly basis would strike a balance between the burden on issuers and the ability of investors to receive up-to-date information in a timely manner for their due diligence (it should be noted that value indexations are typically updated on a quarterly basis and loan repayments on a monthly or quarterly basis).



Conditions for soft bullet and CPTs

The EBA has considered the requirements in the proposed harmonised framework in light of the recent expansion of non-standard amortisation structures of covered bonds— allowing short-term extension of maturities (in case of soft bullets), or long-term extension of maturities by switching the bond to a pass through mode (CPT).

More concretely, it has been considered whether such dauses should qualify as covered bonds (Step I) or should be eligible for access to preferential risk weight treatment (Step II). On the one hand, these clauses address the liquidity and maturity mismatch risks associated with the traditional covered bond structures, thus avoiding default of the covered bond in a technical sense and potentially enhancing maximisation of repayment to covered bond investors.

On the other hand, they involve a higher level of complexity, incorporate non-uniform features and introduce changes to the structural characteristics of the covered bond product, while they are not subject to specific harmonised regulatory treatment at EU level.

Depending on their individual setting, these clauses may question the dual recourse principle (e.g. the recourse to the issuer if the maturity extension is invoked too early while the issuer is still solvent or at the full discresion of the issuer; or the recourse to the issuer's insolvency estate if the repayment of the extended bond is significantly delayed).

Furthermore, they may expose the investors to additional risks (e.g. by transferring the liquidity and interest rate risks from the issuers to the investors), and may pose difficulties for investors in the pricing of such covered bonds. EBA suggests these aspects are assessed further, in the context of the impact assessment related to the use of specific types of amortisation structures of the covered bonds, as recommended in the section 'e' of this chapter.

Taking this into account, the EBA proposes a set of specific conditions that should be complied with by the covered bonds involving the soft bullet and CPT modes, in addition to all the requirements in Step I, in order to allow these covered bonds access to Step I—i.e. to consider them compatible with the covered bond definition and eligible for regulatory recognition under Step II. Consequently, these covered bonds should be eligible for the preferential risk weight treatment, if they comply with all the requirements under Step I and Step II and the specific conditions set out below.



The conditions applicable to the soft bullet and the CPTs are the following:

- The maturity extension may not be effected at the discretion of the issuer;
- The maturity extension may only be effected upon the following triggers (both triggers must occur cumulatively): (i) the covered bond issuer defaulted⁴⁹; and (ii) the covered bond breaches pre-defined criteria/test indicating a likely failure of the covered bond to be repaid at the scheduled maturity date;
- The maturity extension may also be effected ahead of the triggers mentioned above, however
 only at the discretion of the special administrator and provided that the special administrator
 assesses other available options as insufficient to repay the relevant covered bond (i.e. the
 maturity extension must be assessed as suitable and necessary for redeeming the covered
 bond and maximising repayment of covered bond investors' principal and (accrued) interest,
 as well as other relevant liabilities);⁵⁰
- This should not exclude the possibility of maturity extension/cease-payment orders that may
 be issued by competent authorities as part of their prompt corrective supervisory actions or in
 situations when the covered bond issuer is unable to repay the covered bonds due to
 regulations and/or market conditions as defined by law;
- The order of time subordination may not be inversed for any covered bond investor affected by the maturity extension;
- Covered bond investors and other pari passu ranking creditors within the covered bond programme must be treated equally after the maturity extension.

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In the case of soft bullets, the trigger (i) may be considered sufficient for the maturity extension. In the case of specialised credit institutions, the default may refer to the one of the sponsoring institution and not the one of the issuer.

For the sake of clarity, the maturity extension may be effected ahead of the triggers mentioned above as long as the issuer is no longer going concern. It can only be effected at the discretion of the special administrator, or cover pool monitor where a ppropriate.



3.5 Step II – Amendments to the CRR

The EBA suggests that the CRR is amended so as to enhance the conditions for access to preferential risk weight treatment of investments in covered bonds as follows:

- Existing provisions on the eligibility of cover assets should be reassessed;
- Existing provisions on disdosure requirements for the issuer should be amended and shifted to the covered bond framework (Step I);
- Additional (new) conditions underpinning preferential risk weight treatment should be introduced relating to (i) substitution assets, (ii) LTV limits for cover assets collateralised on physical property (i.e. for mortgage cover pools), and (iii) minimum effective overcollateralisation at the covered bond level.

Furthermore, the CRR should clarify that covered bonds should be eligible for preferential risk weight treatment as long as they meet the requirements stated in the covered bond framework (Step I) and the conditions for preferential treatment stated in the CRR (Step II).

I. Requirements for eligible cover assets

Under current applicable rules, no restrictions apply to eligibility of cover assets contributing towards the coverage requirement that all covered bonds seeking regulatory recognition would need to comply with (i.e. the UCITS Directive is silent on this matter). The CRR, however, restricts the eligible cover assets for those covered bonds that seek preferential risk weight treatment; these are specified in Article 129(1) of the CRR and are subject to specific conditions as set out in this article (see Annex 1 for the list of eligible cover assets and the condition as per Article 129 of the CRR).

According to this artide, only covered bonds that are collateralised by any of the following eligible asset classes are eligible for preferential risk weight treatment: exposures to, or guaranteed by, EU and third-country public entities; exposures to institutions (up to 15%); and loans secured by residential and commercial mortgages, RMBSs, residential guaranteed loans, CMBSs and loans secured by maritime liens on ships. Current CRR rules do not allow the inclusion of aircraft liens and SME loans in the scope of eligible cover assets. In addition to Article 129(1), certain specific derogations apply to the CMBS and RMBS exposures, as per Article 496 of the CRR. The requirements do not distinguish between primary and substitution assets.

As part of the analysis in 2014 and in response to the Commission's call for advice, the EBA assessed the appropriateness of the preferential risk weight treatment of some specific assets classes. As a follow-up to this analysis, it has concluded that residential guaranteed loans should be maintained within the scope of preferential risk weight treatment, subject to certain criteria. It



also recommended not including aircraft liens in the scope and not renewing the derogation in Article 496 of the CRR on the use of RMBSs and CMBSs as cover assets beyond December 2017.

The EBA has once again looked at the issue of eligibility of cover assets (in the context of the analysis and for the purpose of this report). The EBA considers that the covered bond definition (i.e. the covered bond framework within Step I) should not prescribe any requirements on the eligibility of cover assets. This would allow the covered bond framework within Step I to focus on the structural aspects of covered bond business and to maintain flexibility in the treatment of cover assets in national frameworks.

The EBA considers that more caution should, however, be shown in relation to the eligibility of cover assets for the purposes of preferential treatment (i.e. within Step II). In the 2014 EBA report, the EBA did not support an extension of cover assets for the purpose of preferential risk weight treatment beyond what is currently given in the CRR, in view of better protecting the stability of the covered bond brand and strengthening the comparability of covered bond frameworks across the EU. The EBA reiterates the condusions of the 2014 analysis and considers that the scope of cover assets should not be widened.

Furthermore, following the 2014 analysis, the EBA considers that loans to SMEs, infrastructure loans and loans to additional non-public debtors should not be considered for preferential treatment⁵¹, and further impact analysis should be conducted on the eligibility of ship loans as eligible cover assets.

Last but not least, the EBA recommends to clarify in Art. 129 of the CRR that the requirements on eligible assets only refer to cover assets contributing towards the minimum required coverage (including minimum effective overcollateralisation), and not to the cover assets held in addition to the required level. An issuer should be allowed to post non-Art 129 eligible collateral for the benefit of the covered bond investors after meeting the minimum overcollateralisation levels with the eligible collateral.

m. Limits on substitution assets

The EBA recommends establishing specific requirements in the CRR for substitution assets contributing towards the coverage requirement, which would need to be complied with in order for covered bonds to be eligible for preferential risk weight treatment. Apart from setting out the rules on the eligibility of cover assets (which are understood to cover both primary and substitution assets), the current CRR is silent on the treatment of substitution assets. The EBA's best practices from 2014 do not cover substitution assets; however, the EBA's analysis shows that a significant majority of national covered bond frameworks regulate substitution assets, including their composition and the quantitative limits (the quantitative limits on substitution assets in the

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⁵¹ This is without prejudice to the treatment of the loans secured by residential or commercial properties or guaranteed by public entities, as eligible assets.



cover pool range from 5% to 30%, while a number of jurisdictions set the limit at 15%). As the treatment for substitution assets is linked to the treatment of eligible cover assets, it should be specified in the CRR in the context of Step II.

Taking this into account, the CRR should be amended so as to specify rules on the composition of substitution assets and the quantitative limit on the amount of substitution assets as follows:

- With regard to the composition of substitution assets, all cover assets as specified in the Article 129(1)(a)(b) and (c) of the CRR (i.e. exposures to EU public entities as specified under (a), exposures to third country public entities as specified under (b), and exposures to institutions as specified under (c)) should be allowed as substitution assets contributing towards the coverage requirement, subject to limits on credit quality and exposure size as currently set out in the Article 129(1) (these limits should be applied in relation to the minimum required coverage, including minimum effective required overcollateralization)⁵²;
- With regard to quantitative limit, substitution assets contributing towards the coverage requirement should be limited to maximum 15% of minimum required coverage (including minimum effective overcollateralisation) based on the nominal value. Apart from the nominal value, other forms of calculation should be allowed as long as the limit based on the nominal principle is respected.

n. LTV limits for mortgage cover assets

Setting of LTV limits is a prudential and credit-related issue and should therefore be regulated in the CRR. The current CRR establishes the minimum LTV limits applicable to the mortgage and ship asset classes; however, it does not specify whether the LTV limits are soft coverage or hard eligibility limits.

The EBA considers that the current LTV limits set out in the CRR are appropriate and should remain the same (i.e. they should be set at 80% of the value of the property for residential loans, and at 60% of the value of the property for commercial loans).

The CRR should specify these represent soft coverage LTV limits—i.e. maximum LTV parameters that determine the percentage portion of the loan that contributes to the requirement of coverage of the liabilities of the covered bond programme. It should also be specified that these soft LTV limits should be applied on an ongoing basis throughout the life of the programme.

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 $^{^{52}}$ And hence not the amount of outstanding covered bonds, as currently applicable.



o. Minimum overcollateralisation

Besides establishing the general coverage principle in the UCITS Directive, the current EU regulation does not prescribe a minimum overcollateralisation level. The EBA observes that overcollateralisation is a tool widely used across national covered bond frameworks for mitigation of the most relevant risks arising in the issuance of covered bonds, in a scenario of the issuer's insolvency or resolution.

The EBA considers that, while all covered bonds should comply with the general coverage requirement, only those complying with the minimum effective level of overcollateralisation should be eligible for preferential risk weight treatment (irrespective of whether or not the overcollateralisation requirement is anchored in the national legal/regulatory framework). Hence, the CRR should prescribe a minimum effective overcollateralisation level for covered bonds as one of the conditions for preferential risk weight treatment.

The CRR should establish the following:

- The minimum <u>effective</u> overcollateralisation level—i.e. the excess of the total amount of cover assets over the total amount of all liabilities attached to covered bonds, which the EBA suggests be set at 5%. However, it is recognised that the amount should be carefully calibrated based on an impact assessment and should be able to cover for relevant credit-related risks while avoiding undue asset encumbrance. Scope of the cover assets and liabilities attached to covered bonds and their calculation should follow the same rules as specified in Step I dealing with the coverage requirement;
- The minimum overcollateralisation level should be set at a uniform level. Differentiation of levels for different asset classes is not considered necessary and desirable, provided that fully uncollateralised claims of general debtors are not included as eligible assets;
- With regard to the percentage limits on exposures as currently set out in Art. 129(1) of CRR (such as 15%/10% limits on exposures to institutions), these should continue to apply; it should be clarified that these apply in relation to the minimum required coverage, including minimum effective required overcollateralisation⁵³. These limits should not apply to any exceeding voluntary overcollateralisation.

As evidenced in the analysis of the BRRD's implications on covered bonds, there is currently insufficient clarity regarding the treatment of <u>voluntary</u> overcollateralisation (i.e. in excess of the minimum required level) during a resolution process (e.g. in the case of bail-in and partial transfers), as the BRRD does not specify this issue. The EBA recommends that this aspect is clarified in statutory law. With regard to partial transfer, the EBA considers that voluntary overcollateralisation available at the time of transfer should be subject to segregation requirements and, as such, must not be separated from the liabilities for which it serves as

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 $^{^{\}rm 53}$ And hence not the amount of outstanding covered bonds, as currently applicable.



collateral. In any case, partial transfer must not lead to undercoverage of the part of the covered bond programme that has not been transferred.



3.6 Step III – Voluntary convergence

The EBA is aware of concerns from some members relating to the harmonisation of certain specific areas of the covered bond business. As such, the EBA recommends and encourages voluntary convergence between national frameworks in areas where further harmonisation is seen as beneficial, but not where harmonisation by means of a binding instrument could potentially have an unintended disruptive effect on the functioning of some national frameworks. Irrespective of the type of instrument that would be chosen to achieve voluntary convergence, and taking into account the non-binding character of harmonisation, the non-compliance with the EBA recommendations in these areas should not have an impact on the eligibility of covered bonds for regulatory nor risk weight treatment. On a longer-term, also greater harmonisation could be pursued in these areas, but at the current stage, these issues are assessed to be secondary compared to the robustness of the covered bond product.

p. Composition of the cover pools

Apart from setting out types of eligible cover assets, the CRR does not stipulate additional rules on the composition of cover pools. The EBA presents the following recommendations, so as to limit the complexity of assessments of the cover pool's risk profile by covered bond investors and to facilitate the investors' thorough understanding of this risk profile:

- Homogeneous pools consisting exclusively of one primary asset dass (not taking into account asset dasses included in the pool as substitution assets) should be preferred in principle. Nevertheless, for mortgage (residential and commercial) loans, mixed pools could be considered;⁵⁴
- Mixed mortgage cover pools comprising both residential mortgage (or guaranteed) loans and
 commercial mortgage loans should be subject to appropriate disclosure and safeguards and
 should be structured and managed so as to ensure that the composition by mortgage type
 (residential vs commercial), which characterises the pool at issuance, does not materially
 change throughout the life of the covered bond for reasons other than the amortisation
 profile of the cover assets.

In the 2014 EBA report, the EBA recommended regulatory limits on the composition of the mortgage pools to ensure that a certain degree of consistency is maintained in the cover pool's risk profile throughout the life of the covered bond. The EBA also acknowledged that other tools may equally ensure consistency and stability in the composition of mixed cover pools, including contractual arrangements on the composition of the mixed cover pools and the supervision on the composition of mixed pools based on supervisory guidelines.

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 $^{^{54}}$ A broad range of claims on/guaranteed by public sector entities are considered as one asset class.



Encouragement of voluntary convergence is considered an appropriate way towards harmonisation in this area. The concerns expressed by jurisdictions in relation to the obligatory harmonisation of the composition of cover pools through legislative means reflect various factors (e.g. issues with implementation of requirements for mixed pools in jurisdictions with a principle of unitary cover; possible difficulties that the requirement for a single asset class might cause in terms of compliance with the LCR criteria; and established use of the composition of the cover pool to mitigate concentration risks).

q. Cover pools with underlying assets/obligors located in jurisdictions outside the EEA

The current EU legislation does not stipulate requirements on the treatment of cover pools in cases where the underlying assets (in the case of mortgages) or obligors (in the case of other loans) are located in jurisdictions outside the EEA. The EBA recommends the following:

- Location of the cover assets/obligors is limited to the EEA or to jurisdictions whose applicable supervisory and regulatory requirements have been assessed by the Commission as being equivalent to the EU framework for the purposes of the prudential treatment of credit risk, as this ensures that liquidation of collateral in the case of the issuer's insolvency is legally enforceable;
- In the case of cover assets/obligors located in a non-EEA or non-equivalent jurisdiction, the following should be assessed:
 - For cover assets that are residential or commercial mortgages, it should be
 ensured that the requirements provided for in Article 208(2) of the CRR are met
 and that the priority claim of the covered bond investor is legally enforceable in
 an issuer's insolvency scenario in the jurisdiction under consideration. For cover
 assets other than mortgages, it should similarly be ensured that access to cover
 assets is legally enforceable;
 - Underwriting standards are similar to the ones applied on comparable loans granted in EEA jurisdictions and the loans should have similar risk characteristics;
- The laws of non-EEA jurisdictions are comparable in terms of the legal position of (secured) creditors and also, in practice, do not discriminate against non-domestic creditors in the exercise of that legal position;
- The result of such assessment should be notified to the EBA.

Encouragement of voluntary convergence is considered as an appropriate way towards harmonisation in this area. While some jurisdictions emphasised the necessity and feasibility of legal enforceability for access to cover assets in different countries, other jurisdictions found



obligatory regulatory requirements to be undesirable. Some of the arguments presented included successful and established practices with the use of collateral originating from third countries in cover pools (particularly with public sector loans) and the risk of possible retaliatory actions on the part of the third countries, which might (in turn) prove detrimental to the liquidity and stability of the covered bond market more broadly.

Taking into account current regulatory developments at an international level for covered bonds, the EBA sees an opportunity opening up for a convergence towards a common approach for determining capital requirements for covered bonds. Subject to the recognition of equivalence, the EBA therefore considers that there would be grounds for enlarging the definition of covered bonds in Step I to issuers from non-EEA jurisdictions. This should, however, be done in a prudent manner and should be based on a thorough assessment of the covered bond regimes applicable to non-EEA covered bonds.

r. LTV measurement and frequency of monitoring/revaluation

The current CRR sets out rules on the criteria and frequency of monitoring for property values and property valuation in Article 208 and Article 229(1) of the CRR. The EBA recommends that these rules should be expanded, subject to voluntary convergence, as follows:

- Where cover asset eligibility is based on loan-to-market value limits, the value of the property securing a particular loan—and the corresponding regulatory LTV limit determining the contribution of that loan to the coverage requirement—are monitored and updated (e.g. at least via an indexation or other statistical method) at least on a yearly basis for both residential and commercial properties, and more frequently where either the management of the covered bond programme or the cover pool monitor or the competent authority deem appropriate;
- Where cover asset eligibility is based on loan-to-mortgage lending value limits, the general level of market prices for the relevant real estate market is to be monitored and the basis of valuation of property collateralising individual loans is to be reviewed (as a minimum) when a general reduction in market prices suggests an impairment of the mortgage lending value, or if the affected loan becomes delinquent;
- Revaluation of the properties securing the loans should be based on transparent valuation rules and be carried out by an agent who is independent from the credit granting process. As a minimum, the valuation process should be compatible with either the conditions laid down in the first or the second subparagraph of Article 229(1) of the CRR;
- When deciding upon the frequency of revaluation, qualitative aspects such as robustness of the revaluation process should also be taken into account.



s. Stress testing by the covered bond issuer

The EBA recommends that the covered bond issuers carry out regular stress test exercises on the calculation of the coverage requirement, taking into account the main risk factors affecting covered bonds (such as credit, interest rate, currency and liquidity risks), as well as publish the summary of such stress tests (including the inputs and outputs).

The EBA considers this would contribute to the economic robustness of covered bond programmes, as it would enable the issuers to identify trends, potential risks and vulnerabilities of these programmes. The stress tests should represent a behavioural requirement for the issuer with the objective of proactively assessing potential risks affecting covered bonds, rather than a requirement for the issuer to reflect the shortfall amounts identified in such stress tests in additional coverage.

Taking into account differences between the business models of the issuers and the need to incorporate adequate proportionality while avoiding unnecessary burden on the smaller issuers, the EBA suggests that the execution of such stress tests, the factors to be considered for such stress tests, and the publication of the results are subject to voluntary convergence rather obligatory requirement.

The factors that could be taken into account in such stress tests could—subject to data availability—include:

- Shifts of relevant interest rate curves based on historical performance;
- Shifts of the currency pairs relevant to the covered bond programme based on historical performance;
- Shifts of the credit spread premiums attributable to uncollateralised cover assets based on historical performance;
- Stresses on the repayment behaviour of those underlying assets for which prepayment without compensation is legally possible, based on historical performance;
- Stresses on the market price of physical assets on which the underlying assets are collateralised (based on historical performance) against corresponding amounts used for coverage and taking into account prior liens.

The stress test could also take into account other risks—including, but not limited to, set-off risks and commingling risks—to the extent that these risks are relevant to the covered bond programme.

It is also recommended that convergence be encouraged with regard to the type of simulation (static simulation should be allowed for proportionality reasons), methodology, scenario, frequency of conducting stress tests, and additional terms of publication.



3.7 Suggestions for addressing observed inconsistencies in the CRR

A few inconsistencies have been observed regarding Article 129 of the CRR, which could be addressed in the context of amendments to the CRR:

Assessment of the waiver in Art. 129(1)3rd paragraph:

Article 129(1)(3) of the CRR (the waiver) refers to an assessment by the competent authority (within the CRR meaning) of potential concentration problems in Member States, which ultimately may result in cover asset eligibility of claims on CQS 2 institutions up to a level of 10%.

Since Article 129 of the CRR refers to investing institutions, the competent authority within the SSM is the ECB for significant institutions. However, eligibility of assets for covered bond coverage purposes is typically regulated at the level of the national covered bond regime (thus, it is not related to prudential supervision of the issuer, which is carried out by the ECB for significant institutions). It might therefore be reasonable to clarify within the CRR that the respective decision on the application of the waiver, and the consultation with the EBA, is performed by the authority responsible for special public supervision of the covered bond issuer, and not by the competent authority responsible for the prudential supervision of investing institutions.

In addition, it could also be clarified to which Member State the potential concentration problems in the Art. 129(1)(3) refer to (i.e. to all Member States, that of the investing bank or that of the issuer, the latter being preferable).

Application of Art. 129(3):

It should be clarified that Article 129(3) of the CRR refers to the credit institution issuing the covered bonds and not to investing institution, since compliance with the Articles 208 and 229(1) of the CRR (to which the Article 129(3) refers) by the investing institution is not conceivable.

On the other hand, it is clear that the purpose of the Articles 208 and 229(1) of the CRR is to set some minimum 'quality' standards in respect to the real estate assets that are part of the cover pool. In this sense, these should not be regarded as requirements solely for the issuer but rather as standards that the investing institution needs to verify in the context of its investments, in order for the investments to qualify for preferential treatment under Article 129 of the CRR.



Treatment of derivative exposures:

The following issues with respect to the application of Article 129(1)(c) of the CRR to derivative exposures should be clarified:

- The size of the derivative exposures should be measured based on market (mark-to-market) value;
- The collateral received under the derivative agreements should be considered in the determination of the exposure value of derivatives under the respective article to the extent segregated for the benefit of covered bondholders; and
- The maturity of the derivatives should be understood in the context of swap reset dates and collateral posting frequency, which should fall within 100 days, which are permitted under the CQS 2 exposures.



Annexes

Annex 1: Eligible classes of cover assets and related conditions as per Article 129 of the CRR

Art. CRR	Type of exposure	Specification of exposure	Conditions on the type of exposure	Limit on the exposure	
		EU central governments		-	
129 (1)A	Exposures to or guaranteed by	ESCB central banks		_	
(-)	g,	EU public sector entities		None	
		EU regional governments		•	
		EU local authorities		-	
	Exposures to or	Third-country central government	CQS 1		
129	guaranteed by	Third-country central bank	CQS 1	All :	
(1)B		Multilateral development bank	CQS 1	All exposures in the section B:	
		Int. organisations	CQS 1	If CQS2: max 20% of the	
	Exposures to or guaranteed by	Third-country public sector entity	CQS 1 and risk weighted as exposures to institutions or central governments and central banks as per Article 115(1) or 115(2)	nominal amount of outstanding	
	guaranteed by	Third-country regional government	CQS 1 and risk weighted as exposures to institutions or central governments and central banks as per Article 116(1)	covered bonds	
		Third-country local authority	CQS 1 and risk weighted as exposures to institutions or central governments and central banks as per Article 116(2) or 116(4)	-	
129		Institutions	CQS 1	CQS 1 + CQS 2: max 15% of	
(1)C	Exposures to	Institutions: maturity < 100 days	CQS 2	outstanding covered bonds	
129 (1)D	Loans secured by	Residential mortgages	LTV 80%	None	
(1)0	residential	residential mortgages and	RMBSs	90% backed by mortgages on residential with LTV of 80%	Max 10% of
	RMBSs	NVID33	CQS 1	outstanding covered bonds	
			Guarantor as per Article 201 of the CRR [list of eligible guarantors]		
			Guarantor is CQS 2		
129 (1)E	Residential guaranteed loans		LTV 80%	•	
			LTI 33% – Based on gross income	-	
			No mortgage lien when the loan is granted	. None	
			From 1 January 2014: no mortgage lien can be granted without consent of credit institution that granted the loan	None	
			Guarantor is: prudentially supervised financial institution or institution or insurance company	<u>-</u>	
			There is a mutual fund for sharing credit risk	• •	
			Calibration of mutual fund periodically reviewed by the national authority Originating institution and guarantor shall both carry out creditworthiness	-	
			assessment		
			LTV 60%	None	
129 (1)F	Loans secured by commercial	Commercial mortgages	LTV 70% if overcollateralisation is at least 10%		
	mortgages and		90% backed by mortgages on commercial mortgages with LTV 60%	Max 10% of	
	CMBSs	CMBSs	CQS1	outstanding covered bonds	
129 (1)G	Ship loans		Limited to the difference between 60% of ship value and prior lien on ship (i.e. LTV 60%)	None	

 $[\]overline{}^{55}$ If wa iver according to Art. 129(1) 3^{rd} paragraph applies, exposures to CQS2 institutions can be allowed to up to 10% of outstanding covered bonds



Annex 2: Overview of national covered bond frameworks

Juris- diction	State of play	Current covered bond framework	Structure of the issuer	Changes of the covered bond framework since publication of the 2014 EBA 2014 report
Austria	Amendments on hold	The covered bond framework is composed of three legislative acts: • HypBG: Mortgage Banking Act (1899); • FBSchVG: Covered Bond Act (1905); • PfandBG: Mortgage Bond Act (1927). All three acts have been last amended in 2010.	Covered bonds are issued by universal credit institutions with a special licence to issue covered bonds. The banks can issue two kinds of covered bonds: Pfandbriefe, which are issued under the Mortgage Banking Act and the Mortgage Bond Act; and Fundierte Bankschuldverschreibungen (FBS) is sued under the Covered Bond Act.	No changes; a mendments are on hold. All three acts have been last a mended in 2010. A harmonisation of the three existing legislative acts is intended, as is strengthening the legal requirements especially on transparency/reporting requirements and risk management. A concrete timeline has not been fixed yet.
Belgium	No changes	 The covered bond framework is composed of: Covered Bond Law, as part of the Banking Law (2012) and the Mobilisation Law (2012); Technical details of the framework are set out in two regulatory Royal Decrees approved by the finance minister and the government (Covered Bond Royal Decree 2012 and Cover Pool Administrator Royal Decree 2012), and two regulations adopted by the National Bank of Belgium (NBB) (NBB Covered Bonds Regulation 2012 and NBB Cover Pool Monitor Regulation 2012). 	Covered bonds are issued by universal credit institutions that need to be licensed by the NBB as covered bond issuers (general authorisation as issuer).	No changes since the implementation of the covered bond framework in 2012. Currently, no reform is ongoing.
Cyprus	No changes	 The covered bond framework is composed of: The Covered Bond Law (130(I)/2010), which is a primary legislation on the issuance of covered bonds; Directive (issued by the Central Bank of Cyprus, 526/2010); Other supplementary laws (e.g. the Bankruptcy Law, the Banking Business Law, the Companies Laws). 	Covered bonds are issued by universal credit institutions subject to one-off covered-bond-specific licensing. Credit institutions as defined under the law are: banks, cooperative credit institutions, and the housing finance corporations.	No changes. Currently, no reform is ongoing.
Czech Republic	Amendments in process	The covered bond framework is composed of: The Bond Act (entered into force in 2004, latest amendments in 2012); The Insolvency Act (182/2006). The central bank/supervisory authority adopts supplementary legislation and public administration measures. Before 2004, it was possible to issue mortgage covered bonds from 1992 on the basis of general regulation contained in the Commercial Code.	Covered bonds are issued by universal credit institutions that hold a banking licence (general banking licence). The framework allows the issuance of the mortgage covered bonds (hypotecni zastavni list).	Substantial amendments to the covered bond framework are in the process, driven primarily by the objective to align the framework with the EBA's best practices. Adoption is expected in 2017.
Denmark	No changes	The covered bond framework is composed of:	Covered bonds can be issued by specialised credit	No changes.

 $^{^{56}}$ Amended (since the 2014 EBA report); amendments in process; a mendments on hold; no changes.



Juris- diction	State of play	Current covered bond framework	Structure of the issuer	Changes of the covered bond framework since publication of the 2014 EBA 2014 report
		 The Mortgage-Credit Loans and Mortgage-Credit Bonds Act (i.e. the Mortgage Act) – Only applicable to mortgage (specialised) banks; The Financial Business Act; Specific bankruptcy regulations in the Financial Business Act and the Mortgage Act. The main laws can be supplemented with executive orders made by the supervisory authority. The supervisory authority can make supervisory reactions and memorandums as interpretations of the applicable law. 	institutions (subject to special authorisation as mortgage credit institutions) or commercial banks (universal credit institutions, subject to specific authorisation to issue covered bonds). A significant majority of the issuers are specialised mortgage banks that operate under a specific covered bond system based on the balance principle and issuance of covered bonds in series—i.e. capital centres. There are three types of Danish covered bonds: Saerligt daekkede obligationer (SDOs) issued by either commercial or mortgage banks, and which are both UCITS- and CRR-compliant; Saerligt daekkede Rralkreditobligationer (SDROs) issued exclusively by mortgage banks, both UCITS- and CRR-compliant; Realkreditobligationer (ROs) issued exclusively by mortgage banks, which are UCITS-compliant.	
Finland	No changes	The covered bond framework consists of: • Act on Mortgage Credit Bank Operations (HE 42/2010); • Guidelines issued by the supervisory authority.	Covered bonds can be issued by universal banks or specialised mortgage banks that need to be authorised/licensed to engage in mortgage credit bank operations (i.e. issuing covered bonds).	No changes.
France	Amendments in process	There are two different covered bond frameworks. For OFH and OF: 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; Banking and Financial Regulation Act no 2010-1249 of 22 October 2010; Amendment in Decree no 2014-526 of 23 May 2014; Arrêté of 26 May 2014. For the CRH: French Monetary and Financial Code Articles L.313-42 to 313-49 and Articles L.515-14-1; Article 13 Law no 85-695 of 11 July 1985.	Covered bonds are issued by duly licensed specialised credit institutions. There are three main covered bond structures, depending on the type of the issuer: SCF, issuing OF; SFH, issuing OFH; Duly licensed specialised credit institutions, issuing CRH bonds.	The French covered bond regime has been reinforced thanks to new servicing requirements following the adoption of the 'Sapin II' law. These new requirements should allow the French regime to become fully aligned with the bankruptcy remoteness best practice once fully implemented by French issuers by end of 2016. Legal changes in the covered bond framework are scheduled for the second semester of 2016.
Germany	Amended	The covered bond (Pfandbrief) framework is composed of three main instruments: The Pfandbrief Act (2005); Five (potentially six) regulations based on the Pfandbrief Act. These are: present value regulation (PfandBarwertV), cover register regulation (DeckRegV), and three regulations for the determination of mortgage lending values (for properties	Covered bonds are issued by universal credit institutions; furthermore, a special licence for Pfandbriefe issuance is required. The licence for Pfandbrief business may be restricted to any combination of the four Pfandbrief types (mortgage, public sector, ship, and aircraft). The Pfandbrief law applies a principle of unitary cover—	Major changes since 2014 include the following. The German BRRD Implementation Act: changes pertaining to Pfandbrief Act entered into force in December 2014: Claims on CQS 2 credit institutions with original maturity not exceeding 100 days are made eligible as liquid overcollateralisation and supplementary cover; BaFin is assigned the right to issue a general administrative order to allow claims on domestic CQS 2 credit institutions for



Juris- diction	State of play	Current covered bond framework	Structure of the issuer	Changes of the covered bond framework since publication of the 2014 EBA 2014 report
		(BelWertV), for ships (SchiffBelWertV), and for aircraft (FlugBelWertV)). Regulations may rule only on issues within their legal mandate as provided by the authorisation in the Pfandbrief Act; • Special public supervisor's practice (general interpretations, and interpretations established explicitly in the course of cover pool audits).	i.e. one cover pool per Pfandbrief type (e.g. mortgage Pfandbriefe) covers all liabilities incurred from issuing Pfandbriefe of that type. A Pfandbrief bank cannot decide to open up an additional cover pool covering a new set of Pfandbriefe (to this end, a new Pfandbrief bank would have to be established).	coverage on the same footing as claims on CQS 1 credit institutions, if there was a danger of a material credit concentration due to the CQS 1 restriction (10% limit had already been in place previously); BaFin is vested with the authority to require individually higher coverage than the legal minimum; Geographical scope of mortgaged properties widened to include properties in Australia, New Zealand and Singapore; Reshaping of the requirement of insurance for mortgage-lending value-increasing buildings against damage to include a 'probable maximum loss'—a concept established in international insurance practice; Changes related to cover pool eligibility or, more specifically, the ability to be registered to a cover pool of future account balances held with central banks and credit institutions; Introduction of a Pfandbrief-related regular (generally quarterly) reporting; Several modifications to the disclosure requirements, most notably the introduction of a loan-size-based distribution for public sector Pfandbriefe. Waiver (relating to Article 129(1)(3) of the CRR) has been issued in December 2014 (effective from January 2015) to the effect that claims on domestic credit institutions externally rated to CQS 2 may be used for coverage of Pfandbriefe. SRM transposition act, changes pertaining to the Pfandbrief Act entered into force in November 2015: Changes relating to public sector Pfandbrief only, with respect to extra EEA cover assets and the Pfandbrief creditors' preferential claim over the cover assets in the issuer's insolvency; Adjustments to deal with the implications of involuntary transfers of cover assets and Pfandbrief liabilities made—e.g. in the context of the implementation of the BRRD.
Greece	Amendments in process	The covered bond fra mework consists of: The Covered Bond Law (Article 152 of the Law 4261/5.5.2014); The Bank of Greece's Governor's Act 2620/28.6.2009; The legislative framework is supplemented by the Bond Loan and Securitisation Law 3156/2003.	Covered bonds are issued by universal credit institutions, subject to compliance with specific requirements.	No changes. The current covered bond regime is under review in order to incorporate the EBA's best practices in addition to those already in place. The assessment of the current frame work and possible reform is estimated to be completed by end 2016.
Ireland	Amendments on hold	The covered bond framework consists of: Asset Covered Securities Act (ACS Act, 2001 and amended 2007); Related central bank regulations and regulatory notices.	Covered bonds are issued by specialised credit institutions that are registered as DCIs and have limited business activities. Each issuer is registered as a Designated Public Credit Institutions (authorised to issue public credit covered securities) and/or a Designated Mortgage Credit Institutions (authorised to issue mortgage credit covered securities).	No changes. Amendments on hold pending the results of EU activities in this field. After the publication of the 2014 EBA report, the authorities of Ireland afforded consideration to align the existing covered bond legislation with the EBA's best practices, notably in relation to stress testing, liquidity buffers and disclosure, as well as the interaction between the ACS Act regime and the BRRD. The reform has been put



Juris- diction	State of play	Current covered bond framework	Structure of the issuer	Changes of the covered bond framework since publication of the 2014 EBA 2014 report
				on hold to a wait the conclusion of the Commission's review of the covered bond regulation in the EU.
ltaly	No changes	 The covered bond legal framework consists of: Securitisation Law no 130/1999; Ministry of Economy and Finance Decree no 310/2006 (secondary law); Ministry of Economy – President of CICR Decree no 213/2007 (secondary law); Bank of Italy Circular no 285 – Regulation for the supervision of banks. Under decree law 18/2016 Article 13-bis, converted into law in April — law 49/2015 — the legislation introduced a new instrument Obbligazioni Bancarie Collateralizzate (OBC) with some similar features to the covered bond, with double recourse and the following eligible assets in the cover pool: SME loans, corporate bonds, and ship loans an receivables arising from factoring and leasing contracts. 	Covered bonds are issued by credit institutions through the SPV. The eligible assets are transferred to the SPV, which purchases them by means of a loan granted or guaranteed to it by a bank (which does not necessarily need to be the same bank transferring the assets). The loan is repaid only after all covered bonds have been paid back. Specific requirements apply to the issuer bank (as well as to the transferring bank if it is not an issuer) for the issuance of covered bonds: own funds not lower than EUR 250 million and a total capital ratio not lower than 9%. There is no special banking licence principle.	No changes. The last review of the secondary legislation on covered bonds was conducted and adopted on June 2014. The reform has: Reduced the own funds requirement of the issuers from EUR 500 million to EUR 250 million; Aligned with the CRR the capital ratios to which limits for transferring the cover assets to a SPV are associated; Specified (in greater detail) the asset monitor's tasks.
Luxembo urg	No changes	 The covered bond framework consists of the following: The issuance of covered bonds is regulated by the Law of April 1993 on the financial sector, as amended. These articles relating to covered bonds were introduced by the Act of November 1997 for banks issuing mortgage bonds and amended by the Acts of June 2000, October 2008 and June 2013; The prudential expectations with respect to certain aspects of the covered bond legislation are further defined into two circulars issued by the supervisory authority (CSSF): Circular CSSF 03/95 'Banks issuing mortgage bonds: Minimum requirements regarding management and control of the pledge register, coverassets and the limit of mortgage bonds in circulation', which defines the minimum requirements for the maintenance and control of the cover bonds register (the cover register) and the cover assets; Circular CSSF 01/42 'Mortgage bond banks: Rules on real estate valuation' (as a mended by Circular CSSF 13/568), which lays down the rules for the appraisal of real estate. This Circular is currently under review. 	Covered bonds (Lettres de Gage) are issued by specialised credit institutions, with a specialist bank licence and restricted business activities (mortgage lending, public sector financing, lending guaranteed by movable assets, and provision of loans to credit institutions belonging to a system of institutional guarantee). There are four types of covered bonds, used for financing the above-mentioned activities of the issuers: Lettres de Gage Hypothécaires, Lettres de Gage Publiques, Lettres de Gage Mobilières, Lettres de Gage Mutuelles.	No changes.
Netherla nds	Amended	The regulatory framework in the Netherlands came into force in 2008. The framework was subject to amendments in 2014, which came into force on 1 January 2015 and currently consists of the following: • The Financial Supervision Act (FSA).	Covered bonds are issued by licensed credit institutions through the SPVs (Covered Bond Company (CBC)). The cover assets are transferred to the CBC in the form of an assignment to the CBC under a guarantee support agreement. The CBC can	At the time of publication of the 2014 EBA report, the covered bond law in the Netherlands (first introduced in 2008) was in the process of being revised and the EBA report had taken into account the draft of the reform available at the time. The final revised covered bond law was subsequently incorporated into the jurisdiction's FSA, which came into force in January 2015 and which implemented



Juris- diction	State of play	Current covered bond framework	Structure of the issuer	Changes of the covered bond framework since publication of the 2014 EBA 2014 report
		Further detail is provided in: The Decree on Prudential Rules under the FSA; The FSA Implementing Rules on registered covered bonds.	(and, in practice, does) give a right of lien over the cover assets to another separate legal entity (the Security Trustee).	additional changes with respect to the draft reform considered in 2014. Among other requirements, the 2015 reform introduced in statutory law (i) a minimum nominal overcollateralisation requirement, (ii) a liquidity buffer, (iii) the requirement of appointing an external auditor (i.e. a cover pool monitor) and iv) regular reporting requirements. Furthermore, the following elements of the Dutch covered bond law have been amended, compared to the 2014 EBA report: (i) the legislation now specifically sets out types of assets allowed as covered assets; (ii) market value is used for cover pool valuation purposes, whereas previously the foreclosure value was used; (iii) the definition of liquid assets was made broader; and (iv) the independence of the cover pool monitor, as well as that of other third parties involved in the covered bond issuance, is also considered ex ante when granting a covered bond license to an issuer.
Norway	Amended	The covered bond framework consists of the following: The Act on Financial Undertakings and Financial Groups (chapter 11), which entered into force on 1 January 2016; The Act is supplemented by regulations on mortgage credit institutions, issued by the Ministry of Finance: https://www.finansnorge.no/en/covered-bonds/legislation/regulations/ .	Covered bonds are issued by specialised credit institutions with a licence to issue covered bonds. The majority of issuers are subsidiaries of individual parent banks, while a few issuers are owned by groups of banks.	The Act on Financial Undertakings and Financial Groups entered into force in January 2016 and introduced the following main changes: (i) the framework treats the covered bond the same as banks in the event of insolvency (as such, they are no longer able to be declared bankrupt, but are placed under public administration if facing solvency or liquidity problems); (ii) the Ministry of Finance is vested with a competence to set a legal minimum overcollateralisation level.
Poland	Amended	 The covered bond framework consists of the following: The key legislation is the Act on Covered Bonds and Mortgage Banks; Other applicable laws are the Bankruptcy Law (amended in January 2016) and Regulation of the Ministry of Finance on mortgage cover calculation, coverage and liquidity tests (introduced in December 2015); The legislation is supported by the Recommendations, Regulations and Resolutions of the supervisory authority and the ministry of finance. 	Covered bonds are issued by a specialised credit institution (mortgage banks) with the supervision of the Polish Supervision Authority. The issued is subject to two licences: the banking licence and consent to start operating activity. Apart from specialized banks there is also one state bank, Bank Gospodarstwa Krajowego (National Economy Bank) which is entitled to issue covered bonds. However, in practice this bank does not use this privilege (the bank issued covered bonds for the last time during 1930's).	A number of legislations have been implemented or amended since the 2014 EBA report, most significantly: • Amendments to the Act on Covered Bonds and Mortgage Banks introduced in July 2015, aimed at introducing among others: (i) the requirement of overcollateralisation of covered bonds, at least 10% of the nominal value of the issuance; (ii) liquidity buffers to secure the servicing of interest on covered bonds over the next 6 months; and (iii) increased limits for refinancing the future mortgage loans by covered bonds, up to 80% of the mortgage lending value of a property; • Amendments to the Bankruptcy Law introduced in January 2016, aimed at repealing former barriers to smooth and timely servicing of the bondholders in case of the issuer's insolvency, and introducing a soft bullet clause according to which the date of the maturity of the bonds is automatically postponed by 12 months at the bankruptcy of the issuer; • Introduction of the regulation by the Minister of Finance on carrying out mortgage cover calculation as well as a coverage test and a liquidity test in December 2015. This regulation sets out detailed conditions and methods for carrying out mortgage cover calculation, the coverage test and the



Juris- diction	State of play	Current covered bond framework	Structure of the issuer	Changes of the covered bond framework since publication of the 2014 EBA 2014 report
				 liquidity test; Amendments to the Resolution No 388/2008 of the supervisory authority on providing the template of the cover asset register (introduced in July 2014 and December 2015) simplifying the process of transferring the loan portfolio to a mortgage bank from another bank; Amendments to Recommendation 'K' on the principles of conduct of the cover asset register, introduced in July 2014 and February 2016; Amendments to Recommendation 'F' on the basic criteria applied by the supervisory authority for the approval of regulations for determining the mortgage lending value of the property, issued by mortgage banks, introduced in July 2014.
Portugal	No changes	The covered bond framework consists of the following: Decree-law 52/2006; Secondary legislation issued by Banco de Portugal: Regulatory acts – 13/2006 and notices 5/2006, 6/2006 7/2006 and 8/2008.	Covered bonds are issued by credit institutions authorised to grant credits guaranteed by mortgages on real estate, which can be either universal institutions or specialised credit institutions (mortgage credit institutions).	No changes.
Romania	Amended	The covered bond frame work consists of the following: Law no 304/2015 regarding the issuance of covered bonds; Regulation no 1/2016 regarding covered bonds issuance activity, issued by the National Bank of Romania.	Covered bonds are issued by universal credit institutions subject to general licence.	The changes to the covered bond law and the regulation introduced in 2015 and 2016 were developed with the objective to comply with the EBA's best practices.
Slovakia	Amendments in process	The covered bond framework consists of the following legislative acts: • Act on Banks (No 483/2001, Part 12); • Act on Bonds (No 530/1990, Part 4 – Articles 14-17); • Act on Bankruptcy and Restructuring (No 7/2005, Part 6); • Act on Supervision of the Financial Market (No 747/2004); • The Mortgage Registry Regulation (No 600/2001).	Covered bonds are issued by universal credit institutions that hold a specific licence to perform mortgage transactions (covering issuance of mortgage and municipal bonds), in addition to the general banking licence. The covered bond regime provides for two types of covered bonds: mortgage bond (Hypotekárny záložný list) and municipal bond (Komunálna obligácia). In practice, the market is dominated by the mortgage bond.	The authorities of Slovakia (Ministry of Finance and the National Bank of Slovakia) are preparing a comprehensive reform of the covered bond framework, with the objective of providing incentives for further developments of the market and to reflect the EBA's best practices. The legislative process will take place in 2016/2017.
Slovenia	No changes	 The covered bond framework consists of the following: The Mortgage Bond and Municipal Bond Act (ZHKO-1), launched in February 2012 (with the amendment in June 2012 and several regulations issued by the Bank of Slovenia in March 2012). The first version of the law was issued in 2006; The Regulations, issued on the basis of the law, issued by the Bank of Slovenia (regulation on the conditions for acquiring an authorisation to issue mortgage bonds and municipal bonds, regulation on the custodian (monitor) of the cover 	Covered bonds are issued by universal credit institutions subject to a special licence for the issuance of covered bonds.	No changes.



Juris- diction	State of play	Current covered bond framework	Structure of the issuer	Changes of the covered bond framework since publication of the 2014 EBA 2014 report
		register, regulation on the matching of cover assets and issued mortgage bonds and municipal bonds and regulation on the inclusion of the derivatives in cover assets); Recommendations issued by the Governing Board of the Bank of Slovenia for managing the records of the cover register.		
Spain	Amendments on hold	The regime of each of the types of covered bonds is detailed in their respective parliamentary law and, in some cases, further developed in their respective royal decree, stemming from the government: • CH and bono hipotecario (BH): Law 2/1981 on the regulation of the mortgage market and Royal Decree 716/2009 that develops certain aspects of Law 2/1981; • CT: Law 44/2002 on measures reforming the financial system (Article 13); • Cédula de internacionalización (CI) and bono de internacionalización (BI): Law 14/2013 on the support of entrepreneurs and their internationalisation, and Royal Decree 579/2014 a mending certain a spect of Law 14/2013.	Covered bonds are issued by licensed universal credit institutions (mainly commercial banks, saving banks and cooperative banks). There are three types of covered bonds in Spain: a. CH; BH; b. CT; c. CI; BI. Most of the outstanding bonds are CH; henceforth, the assessment in this report is focused on this type of covered bond. The main difference between the different types of covered bonds is the assets that are used as collateral: a. Mortgage assets, b. Loans to the public sector; c. Loans to finance exports of goods and services on the internationalisation of firms. Within each asset class, the main difference between 'cédulas' and 'bonos' is that, in 'cédulas', the cover pool is dynamic during the life of the cover bond, while in 'bonos', the cover pool is static.	No changes. Amendments on hold pending the results of EU activities in this field. Following the publication of the 2014 EBA report, a working group—which included the Spanish Treasury, the Bank of Spain and the Spanish Securities and Exchange Commission—started to analyse the harmonisation of the Spanish framework. In parallel, the Treasury conducted a public hearing, in 2014, as a means of gathering the opinion of potential stakeholders on the potential improvement of the regulatory framework of covered bonds (published in 2014, http://www.tesoro.es/sites/def ault/files/Sleg7023.pdf). The main areas for improvement identified in this consultation paper were as follows: Possible reduction of the levels of asset encumbrance of issuing institutions, especially regarding CH; Clarifying the rights of the covered bondholders in case of insolvency of the issuing institution by segregating the cover pool; Indexation of the value of the cover pool assets and, when needed, of their collateral; Redefinition of the eligible assets for each type of covered bond; Additional liquidity management measures; Publication of more complete, transparent and homogeneous information by issuing institutions; Creation of the figure of the asset pool monitor to supervise the fulfilling by the issuer of their obligations. There is no available schedule for changes in national regulation yet, pending the reforms at the EU level.
Sweden	Amended	The covered bond framework consists of the following: The Covered Bond Issuance Act (SFS 2003:1223), which entered into force in 2004; This is complemented by the Swedish FSA's Regulatory Code (FFFS 2013:01).	Covered bonds are issued by banks and credit institutions subject to special licence for the issuance of covered bonds.	An amended covered bond legislation entered into force in June 2016, which includes an overcollateralisation requirement of at least 2%. A waiver in line with Article 129(1)(c) of the CRR has been introduced and entered into force in March 2015, allowing for an exposure to CQS 2 institutions equalling up to 10% of the nominal amount of issued covered bonds.
United Kingdom	No changes	The covered bond framework consists of the following: The Regulated Covered Bond (RCB) Regulations (2008), and the RCB Amendment Regulations (2008, 2011 and 2012), available at http://www.fca.org.uk/firms/systems-	Covered bonds are issued by credit institutions through the SPV. The credit institutions are authorised institutions that meet certain additional criteria set out by the FCA.	No changes.



Juris- diction	State of play	Current covered bond framework	Structure of the issuer	Changes of the covered bond framework since publication of the 2014 EBA 2014 report
		reporting/register/use/other-registers/rcb-key-documents. The RCB Regulations are owned by HM Treasury; The RCB Regulation are complemented by the RCB Sourcebook, which is owned by the FCA.	The cover assets are transferred to the SPV (using a limited liability partnership (LLP)) via an equitable assignment. The cover assets are purchased by the SPV by means of a subordinated intercompany loan granted to the SPV by the issuer, or through a partnership interest in the LLP. In addition, a security trustee entity holds the security over the assets on behalf of the covered bondholders.	

