30 August 2018
Covered Bonds

ECON feedback on the covered bond Directive and Regulation

Piling the pressure on CPT covered bonds

The amendments proposed by the ECON to the European Commission's Directive and Regulation proposals will be an outright negative for the conditional pass-through covered bonds, and may hinder further development of this market. The proposals put AAA rated conditional pass-through covered bonds at a risk weight disadvantage versus any lower investment grade rated CRR eligible (soft) bullet alternative. It also seems peculiar that, in the best quality rating buckets, the proposed risk weight penalties result in higher capital charges for CRR eligible conditional pass-through covered bonds than for senior unsecured exposures. For non-CRR eligible covered bonds on the other hand, the ECON advocates a more favourable risk-weight treatment versus senior unsecured debt, while these bonds will in fact be secured by lesser quality assets.

On 17 August 2018, the Committee on Economic and Monetary Affairs of the European Parliament (ECON) published its draft report on the European Commission's proposals for a Covered Bond Directive. This report was complemented on 21 August 2018 by a draft report on the proposals for a Regulation, intended to amend the CRR Regulation (EU) No 575/2013 regarding covered bond exposures.

The most noteworthy takeaway from these reports is the proposed penalizing risk weight treatment for covered bonds with long maturity extension features, such as conditional pass-through covered bonds. The ECON proposes a gradual increase in the risk weights for covered bonds with maturity extension provisions beyond one year, ranging from an additional five percentage points in the case of maturities that can be extended by up to three years, to as much as 20 percentage points for maturity extension features longer than ten years.

The ECON argues that covered bonds with maturity extension structures longer than one year are riskier and less liquid to investors and therefore should be subjected to a tougher risk weight regime. In our view, given the short history of the conditional pass-through market, these assumptions have never truly been tested. Subjecting the conditional pass-through covered bond market to the proposed risk weight penalties will end up putting conditional pass-through covered bonds at a funding cost disadvantage versus bullet structures. This could halt further development of this market.

In our view, for as long as it is absolutely clear that there can never be an element of issuer discretion regarding the maturity extension, it makes no sense to treat conditional pass-through covered bonds this differently to bullet covered bonds from a risk weight perspective, unless such an approach would be supported a) by empirical evidence or b) a detailed and comparative analysis of all the possible risks and risk mitigation mechanisms involved in extendable versus bullet maturity structures.

In this document we look in more detail at the ECON's amendment proposals, not only with reference to conditional pass-through covered bonds, but also with regard to other aspects of the Directive/Regulation. This includes for instance the ECON's suggested alternative to avoid a double counting between the LCR and 180 days liquidity buffer requirements, its proposals to step-up the efforts on third country equivalent treatment, and the ECON's recommendation for a temporary waiver to Article 129 1(c) of the CRR.

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The ECON amendment proposals

High risk weights for long extendable maturities

Conditional pass-through covered bonds heavily penalized

Increasing risk weight proposals are penalizing for conditional pass-through covered bonds

The suggested amendments of the ECON to the covered bond Directive and Regulation proposals will be heavily penalizing for **conditional pass-through covered bonds** (CPTCB) if adopted. The ECON believes that a possible maturity extension makes covered bonds more risky and less liquid in times of financial distress. It acknowledges that maturity extensions preserve the value of assets by avoiding fire sales, but is also of the view that if asset prices have not recovered after one year, their reduced level will be persistent.

Hence, in the ECON's opinion, maturity extensions of more than one year shift risk from the issuer to the investor. The longer the maturity extension, the more risk is transferred to the investor in the ECON's view. As such the ECON proposes **a gradual increase in the applicable risk weights** for covered bonds with maturity extension features longer than one year under Article 129 of the CRR:

- 5 percentage points increase if the maturity can be extended by at most three years;
- 10 percentage points increase if the maturity can be extended by at most five years;
- 15 percentage points increase if the maturity can be extended by at most ten years;
- 20 percentage points increase if the maturity can be extended by over ten years.

A 20ppt risk weight add-on for extendable maturity structures of more than ten years

The reference length of the possible maturity extension is always the possible extension at the date of issue. Figure 1 gives an overview of the risk weight implications of the ECON's proposals for conditional pass-through covered bonds with a maturity extension of over ten years.

Fig 1 Risk weight implications for conditional pass-through covered bonds under the ECON proposals

CQS	0	1	2	3	4	5	6
2nd best rating equivalent	**AAA**	**AA+ to AA-**	**A+ to A-**	**BBB+ to BBB-**	**BB+ to BB-**	**B+ to B-**	**Below B-**
PCB (Bullet)	10%	10%	20%	20%	50%	50%	100%
PCB (CPTCB 10yr+)	30%	30%	40%	40%	70%	70%	120%
OCB (Bullet)	14%	14%	35%	35%	70%	70%	105%
OCB (CPTCB 10yr+)	34%	34%	55%	55%	90%	90%	125%
Senior unsecured (current CRR)	20%	20%	50%	50%	100%	100%	150%
Preferred senior (Basel III reforms)	20%	20%	30%	50%	100%	100%	150%
Securitisation note 5yr STS+	10%	25%	40%	65%	155%	305%	1250%

Source: CRR, EP, ING

Different arguments against a penalizing risk weight treatment for CPTCBs

In our view, there are different arguments against the introduction of the proposed penalizing risk weight treatment for conditional pass-through covered bonds:

CPTCBs are subject to the same strict regulatory requirements as bullet covered bonds

- Under normal going concern circumstances, conditional pass-through covered bonds behave as and should be treated as standard covered bonds with bullet maturities, similar to hard and soft bullet covered bonds. They are **subject to the same strict regulatory requirements and special public supervision** as bullet covered bonds. Hence in terms of regulatory provisions with reference to dual recourse, asset segregation, asset eligibility, liquidity requirements, risk management or overcollateralization they are subject to the exact same strict standards as bullet covered bonds.

The risk weight proposals for CPTCBs are based upon untested risk and liquidity assumptions

- The ECON argues that the possibility of maturity extensions makes covered bonds on the asset side of bank balances more risky and less liquid in times of financial distress. Given the fact that the public issuance of conditional pass-through covered bonds only started to develop in 2013 this market is still a relatively young market. The **argument that these bonds are more risky and less liquid in times of financial distress is** therefore, in our view, still **an untested assumption**.

- The proposed risk weight treatment is based on risk assumptions regarding the post issuer insolvency repayment mechanisms, without -as far as we are aware- a) empirical evidence or b) support of any risk, stress test or scenario analysis on the actual timely repayment and recovery prospects for covered bondholders comparing bullet and extendable maturity structures on a standalone administered basis (outside rating agency analyses). **A penalizing risk weight proposal** like this **deserves**, in our view, at least **more detailed and in-depth analysis** on all the potential risks involved before considering it.
- Furthermore, the **capital charge** against covered bond exposures should in the first place be a **reflection of** the riskiness of the bonds from a **probability of default and loss given default** perspective (i.e. an expected loss reflection), rather than a consequence of their presumed liquidity. As a matter of fact, the ECON's proposed differentiating risk weight treatment may exactly result in what the ECON argues the conditional pass-through segment already is, i.e. less liquid and with greater issuing challenges than bullet covered bonds under difficult market circumstances.

Recovery prospect can be expected to be more favourable for extensions longer than a year

- The argument that covered bonds with maturity extension features stretching beyond one year are riskier to investors than bullet covered bonds also remains difficult to prove. It is true that in the case of conditional pass-through covered bonds most of the refinancing risks are transferred to investors. It may also even be true that, if asset prices have not recovered after a year, their reduced price level may be persistent. Having said that, post issuer insolvency the **recovery prospects** from the cover pool are surely **supported by maturity extension features that stretch beyond one year**: a) longer extension periods provide better opportunities to sell smaller parts of the cover pool assets at likely lower haircuts compared to the sale of large amounts of assets at once, while b) the long extension periods provide (more) time to receive natural loan repayments from the cover pool at non-distressed price levels.
- Whether conditional pass-through covered bonds are indeed riskier than bullet covered bonds is a lengthy discussion and remains a very difficult question to answer given the fact that the **covered bond market has never witnessed a situation of issuer insolvency** where the covered bonds and assets securing them were indeed segregated from the issuer and managed on a standalone basis.

Investors may have a vote under both structures, weighing earlier (partial) repayment versus recovery given extension

- Furthermore, when push comes to shove, after issuer insolvency **investors may** also **still have a vote** to whether a) they are willing to accept a restructuring of bullet covered bonds into pass-through format if they believe this will improve their recovery prospects or b) in the case of conditional pass-through covered bonds if they do prefer a fire sale of assets and earlier repayment in part over a (potential) full recovery over a longer period of time.
- Taking the possible extension at the date of issue as reference length may also **overestimate the ultimate maturity extension risk**. After all, conditional pass-through structures tend to provide for a bi-annual commitment to sell assets at the best possible price achievable. Various programmes also have higher overcollateralization commitments, including under the amortization test, than bullet covered bonds, which does mitigate the ultimate extension risk. Furthermore, the reasonable assumption that a twelve month extension period is adequate to generate sufficient liquidity to fully repay a soft bullet covered bond in time, would likely also hold for covered bonds with longer maturity extensions features.

The ECON's weight proposals for premium CPTCB are penalizing versus potentially riskier OCB

- Furthermore, the penalizing **risk weight recommendations** of the ECON for conditional pass-through covered bonds **are at odds with the ECON's stance on the risk weights for ordinary covered bonds** (see the section "Other takeaways" in this report). Here the ECON argues that ordinary covered bonds should receive better preferential treatment than unsecured exposures as these bonds are covered and the exposures are secured. The ECON feels this is even more appropriate since STS securitizations have recently been granted special regulatory preference. The proposed risk weight increases for covered bonds with extendable maturities stretching beyond ten years result, for A- or better rated covered bonds, in risk weights that are even worse than the risk weights for senior unsecured exposures in the same rating bucket (see Figure 1).
- The ECON's proposed risk weight treatment for covered bonds with extendable maturities longer than one year also **contrasts with the line of thinking at the rating agencies** where these structures are rewarded with higher ratings or more rating cushion, if these rating agencies are convinced that the overall structural features, including the maturity extension mechanism, indeed serve to sufficiently mitigate refinancing risks.

The CPTCB market is expanding beyond the retained or lower rated bank segments

- Albeit still small in size, **the conditional pass-through market is already proving itself to grow beyond the small number of issuers that purely use these structures for the purpose of retained issuance** or because they would otherwise have been unable to achieve AAA covered bond ratings at given issuer rating levels. For smaller size issuers the choice to issue conditional pass-through covered bonds may for instance also be driven by asset encumbrance / overcollateralization considerations. In Poland, conditional pass-through maturity structures are even part of the legal framework for covered bonds.

Risks should be properly analysed and mitigated before taking penalizing measures

Hence in our view, for as long as it is absolutely **clear that there can never be an element of issuer discretion regarding the maturity extension**, it makes no sense to treat conditional pass-through covered bonds in such a different manner to bullet covered bonds from a risk weight perspective.

Albeit still small in size, CPTCB also serve a purpose to grow the covered bond market

Particularly against a backdrop of all the work that is being done to support the use of covered bonds or a dual recourse alternative such as European Secured Notes (ESN) to support lending growth, it is important to also fully understand extendable maturity covered bonds and the risks involved. Where possible these **risks should be mitigated to an acceptable level, rather than more or less closing down the route altogether**. If the ECON's proposals end up finding their way in legislation the recommended risk weight increases will end up putting conditional pass-through covered bonds at a funding cost disadvantage versus bullet structures. This could halt the further development of this market segment, while in fact the harmonisation proposals never intended to have disruptive market consequences. Asset encumbrance considerations may make smaller size issuers, not able or willing to take the joint funding route, more reluctant to enter the covered bond market if they have to do so in the less expensive bullet format. It may even prompt some issuers which have already conditional pass-through covered bond programmes in place, to reconsider the maturity structure of their bonds in favour of soft bullet. After all under the ECON's proposals, even BBB rated bullet covered bonds would have a more favourable risk weight treatment than AAA rated conditional pass-through covered bonds with maturity extensions of more than ten years. As a matter of fact, after implementation of the Basel III reforms, single A rated preferred senior unsecured bonds would even have similar risk weights as AAA rated conditional pass-through covered bonds. This is peculiar given that preferred senior unsecured bonds remain ultimately exposed to a certain element of bail-in risk, while sufficiently collateralised conditional pass-through covered bonds are shielded from bail-in.

Maturity extension shall only be based on statutory triggers upon approval by the competent authority

Conditional pass-through covered bonds: mitigating the risks

While the Directive proposals merely assure that maturity extension is not triggered at the discretion of the credit institution issuing covered bonds, the ECON proposes stricter maturity extension triggers. Under the ECON's proposals, a **maturity extension may only be triggered in the event of insolvency or resolution of the issuer** and **with the approval by the competent supervisory authority**. Apart from these events, the maturity extension is neither triggered at the discretion of the credit institution issuing the covered bonds, nor is the trigger under a more than negligible influence of this credit institution and its business activities. The ECON is of the opinion that it should be made clear that it would be illegitimate for a bank to indirectly steer the development of a pre-defined trigger, for instance by taking (price and interest rate sensitive) actions that could result in a breach of pre-defined price- and interest rate triggers. Furthermore, in line with the Parliament's own initiative report, the ECON proposes that the type of extension trigger should be established by national law and approved by the competent authority. In the ECON's view this will prevent an abundance of soft triggers, which may be difficult to survey and assess from a financial stability point of view.

The ECB is taking a similar stance on this matter as the ECON. In its opinion on the Directive and Regulation published last week, **the ECB also says that only statutory triggers prescribed by law should be allowed for extendable maturity structures**, while contractual triggers should be excluded. The central bank is of the view that it is not possible to fully exclude the discretional triggering of maturity extension in all member states, due to the applicable differences in the national legal frameworks and potential variation in the contractual provisions of covered bond frameworks, as well as due to differences in how national law treats defaults and non-payment in the absence of prohibitions on voluntary trigger of a default. Contractual extension triggers could furthermore result in significant heterogeneity across covered bonds, which hinders harmonisation. The ECB refers to the EBA's proposed conditions for maturity extension that subject extension to the following cumulative triggers: a) the covered bond issuer must have defaulted and b) the covered bond breaches pre-defined programme collateralization tests. We note that these criteria are also not undisputed for non-SPV asset segregation structures, given that maturity extension of a covered bond here actually aims to avoid an issuer event of default rather than a guarantor (i.e. SPV) event of default as in the case of SPV structures.

In our view, drafting uncontroversial pre-defined maturity extension triggers in legislation, while subjecting maturity extension to approval by the supervisory authority will take away an important part of the perceived risks involved with extendable maturities. These strict regulatory requirements should therefore not be complemented by a more penalizing risk weight scheme for long-extendable covered bonds.

Other takeaways

1) Premium versus ordinary covered bonds

Ordinary covered bond asset eligibility criteria to integrate ESN proposals?

CRR eligible covered bonds should be labelled differently from ordinary covered bonds

In line with its own initiative report from July 2017, the ECON remains in favour of a clear distinction between covered bonds labelled as **premium covered bonds (PCB)** versus **ordinary covered bonds (OCB)**. The label ***"European Covered Bond"*** should only be used for covered bonds that meet all the Directive's requirements, while the label ***"European Covered Bond (Premium)"*** should only be used for covered bonds that meet both the Directive and (amended) CRR's requirements. In the ECON's view, such labelling facilitates the European Covered Bonds framework's intentions to develop and stimulate the smaller non-CRR compliant segment of the covered bond market (ordinary covered bonds), without damaging the quality and reputation of premium covered bonds.

OCBs can be secured by a broad range of assets, including those initially intended to secure ESNs

However, where the European Parliament's own initiative report proposed a **European Secured Note (ESN)** framework as a third tier after PCBs and OCBs, the ECON now takes the view these concepts should be dealt with jointly. The ECON believes that all types of assets, including those the Parliament initially had in mind for ESNs, may in principle be eligible for OCBs.[1] According to the ECON this would support innovation and growth in the OCB segment and is also in line with the broad approach to covered bonds of the current UCITS directive and principles-based nature of the covered bond legislation.

Integration of the OCB and ESN regimes may have unintended side effects on covered bonds

We are not a hundred percent sure however, whether all this should indeed be interpreted as the ECON now taking the stance that the ESN framework should be integrated within the Covered Bond Directive. For one thing, this would contrast with the idea, also recently underscored by the EBA in its assessment of European Secured Notes (ESN), that there should be **a clear distinction between the framework for SME ESNs and covered bonds** to avoid confusion and negative side effects on covered bonds.

SME loans may not meet the eligibility criteria of the ECON for ordinary covered bonds

Furthermore, the ECON's proposed asset eligibility criteria for OCBs do seem to leave **room for a separate ESN framework**. The ECON reiterates its view that OCBs should be liquid and almost risk free and secured by high quality assets. Given that there are no restrictions on the nature of the cover assets, the ECON underscores that their quality has to be assured by adherence to well-tested structural properties of the cover assets in terms of legal requirements (enforceability), asset valuation and risk mitigation. The ECON thereto provides quite a bit more detail on the asset eligibility criteria for non CRR eligible covered bonds (OCB) than the current Directive proposals (see *Appendix 1*).

For instance, assets in the form of exposures to a counterparty that a) has no tax raising powers or b) is not subject to public supervision, should be subject to an ongoing credit assessment by an independent professional third party. Loans to SMEs would likely not have such an ongoing credit assessment and may also not necessarily be secured by a property and as such qualify as physical assets. These loans, would not be able to meet the proposed eligibility criteria for OCBs. This creates a possibility for two conclusions: (1) either the ECON now takes the view that these SME loans should not be eligible at all for a dual recourse instrument, or (2) these loans could still be refinanced separately under an ESN regime. To us this is not a hundred percent clear.

The EBA recently argued against a dual recourse regime for infrastructure loans

The first conclusion would contrast with all the preparatory work recently accomplished by the EBA in this field. In its assessment of ESNs the EBA argues for instance that SME exposures that meet strict eligibility criteria could be structured as dual recourse instrument, while such a structure would be **less appropriate for infrastructure**

[1] In its own initiative report of July 2017, the European Parliament argued that debt instruments covered by assets which are substantially more risky than government debt and mortgages (e.g. non-government-backed infrastructure investments or credits to small and medium-sized enterprises (SMEs)), should not be labelled covered bonds, but possibly European Secured Notes (ESNs). Cover pools of covered bonds (PCB and OCB) should be fully backed by assets of a long-lasting nature which can be valued and repossessed. ESNs could finance riskier activities such as SME credits, consumer credits or infrastructure investments which lack government guarantees.

exposures. Hence (non-government backed) infrastructure loans should in this view ideally not even be financed by a dual recourse instrument.

Granting preferential risk weight treatment to ordinary covered bonds

OCBs should be granted a risk weight equal to 70% of the risk weight of unsecured claims

The ECON does make an important first proposal for the potential preferential risk weight treatment for ordinary covered bonds versus (preferred) senior unsecured instruments. Although PCBs should obtain preferential risk weight treatment over OCBs the ECON is of the opinion that OCBs deserve preferential risk weight treatment over unsecured claims. After all, secured exposures are safer than unsecured exposures. The ECON therefore proposes to grant **ordinary covered bonds a risk weight equal to 70% of the risk weight of unsecured exposures** under a new paragraph 8 to CRR Article 129.

We do note that under the proposed Basel III reforms the risk weight treatment of preferred senior unsecured instruments in the credit quality step (CQS) 2 bucket will improve from 50% to 30% (see Figure 1). At 70% of the risk weight of similarly rated senior unsecured notes, the risk weights for ordinary covered bonds (OCB) would within this particular bucket be very tightly aligned with premium covered bonds (21% versus 20%). This may, in our opinion, also justify reconsidering the risk weight treatment of premium covered bonds within the credit quality step (CQS) 2 bucket to, for instance, 15% as opposed to 20% for CSQ3 bonds.

2) Liquidity buffers

Avoiding double counting of LCR and cover pool liquidity buffers remains complicated

Avoiding double counting between the LCR and cover pool liquidity requirements may leave the cover pool without liquidity

The proposals for a covered bond Directive require that issuers maintain a liquidity buffer of liquid assets, sufficient to cover the net liquidity outflow for a covered bond programme for 180 days. At the same time, the Directive provides member states with the opportunity to not apply cover pool liquidity buffer requirements for periods overlapping with the liquidity requirements under the EU liquidity coverage ratio (LCR) regulation. In the ECON's view, this overlooks the fact that, upon insolvency or resolution of the issuer, the cover pool is segregated from the bank. As LCR liquidity remains within the bank, the **cover pool would be without liquidity reserves for the first 30 days**.

The ECON therefore proposes **a solution that should eliminate double counting**, but in its view preserves the 180 days liquidity in the pool and the 30 days stressed LCR reserve of the bank, even under issuer insolvency. Under the ECON's amendment proposals, member states have to ensure that the qualifying liquid assets will only be eligible for the cover pool liquidity buffer requirements if those assets are not essential for maintaining the credit institution's LCR requirements at least at a level equal to the net liquidity outflows over a 30 calendar day stress period. This should assume that the net liquidity outflow of the covered bond programme over the same 30 calendar day stress period is zero on the grounds of sufficient liquidity buffer contained in the cover pool under the 180 days liquidity requirements.

We are not sure a double counting can actually be avoided for hard bullet bonds under the ECON's proposals

We are not sure this makes things less complicated. For instance, our interpretation of this proposed amendment is that where (hard bullet) covered bonds maturing within 30 days are secured by sufficient liquidity under the 180 days covered bond liquidity requirements (i.e. the expected net outflow related to the covered bond is then assumed to be zero), these liquid assets are not required to be maintained for LCR purposes. However, the 30 days LCR requirements are subject to rating stresses. These could result in a breach of own account bank rating requirements and would consequently assume the transfer of these liquid assets to a third party bank entity. In that particular case, the liquid assets required to meet the stressed 30 days LCR requirements with reference to this particular covered bond may still not at the same time be eligible for inclusion in the cover pool liquidity buffer and a double counting of liquidity may still not be avoided.

Both the Directive and the ECON's amendments could be clearer in referring to the extended final maturity date

What is exactly meant with "final maturity date" for extendable covered bonds?

Also with reference to the **treatment of extendible maturity structures** the ECON's proposed amendments do not necessarily make the Directive more straightforward. Under the Directive proposals, the calculation of the principal for extendable maturity structures may recognize the bonds based upon the final maturity of the covered bond. The ECON believes this should be worded with more clarity. The amendment proposals of the ECON therefore state that member states have to ensure that the liquidity requirements for the repayment of principal are updated after a possible maturity extension so that they always match the payment needs at the time when the principal is due. In our view, it would be a simpler approach to distinguish the "intended due for payment date" from the "extended final maturity date" as usually is done in (extendable) covered bond programme documentation. The Directive proposals in our view intend to provide for recognition of either one of these two dates at national discretion, i.e. national regulators can decide whether the intended due for payment date or the extended final maturity date should be taken as a reference for 180 days liquidity purposes. The ECON's amendment proposals always seem to assume the extended final maturity date as the reference. The 180 days liquidity requirements would here merely have to account for redemption payments after maturity extension, i.e. once the extended final maturity date falls within the scope of the 180 days rule.

3) Pooling

The Directive allows for pooled and joint funding structures…

Intragroup pooling as distinct model integrated in the joint funding proposals

The European Commission's Directive proposals allow issuers to pool cover assets originated by several credit institutions by means of two proposed pooling models: (1) **Intragroup pooling**, where it may be allowed to use group internally issued covered bonds as collateral for covered bonds issued externally by a member of the same group, and (2) **Joint funding**, where residential and commercial mortgage loans granted by a credit institution can be used as collateral for the issuance of covered bonds of a different credit institution. This would grant smaller size institutions access to covered bonds funding by enhancing liquidity and mitigating the costs related to establishing a smaller size and separate covered bond programmes.

…but the ECON proposes to integrate pooled funding in the joint funding option

The ECON is of the opinion that the first model, i.e. **intragroup pooling, could result in less transparent cover pool structures**. More specifically, the externally issued covered bonds could be secured by internally issued covered bonds of other banks belonging to the same group as the cover assets. The ECON argues that internally issued covered bonds would be covered by second-layer cover pools, while there would be no limit to the number of second-layer cover pools contributing to the cover of the first-layer cover pool securing the externally issued covered bonds. In the ECON's view, this may make the structure less transparent which could negatively impact a proper risk assessment by investors, unless the number of internally issued covered bonds would be very small.

The ECON also points out that consistency issues could arise in the case where the group sells off one of the smaller institutions that issued internal bonds as this would result in covered bonds with external covered bonds in their cover pool, which would be in conflict with the European Commission's proposals for intragroup pool structures. The ECON therefore believes that the purpose of **intragroup pooled covered bond structures** (i.e. facilitate the development of covered bond issuance, including in new markets) is **equally well served by the Directive's joint funding proposals** without violating transparency. The small number of Danish banks which currently use intragroup pooled covered bond structures should be granted a ten year transition phase for pooled covered bonds issued prior to 1 January 2018.

The ECON does propose to clarify in the Directive that any number of banks can jointly fund a covered bond issue by contributing eligible cover assets to just one cover pool, provided that the jointly funded covered bond is issued by **one single credit institution** (**the lead institution**). In the case of insolvency or resolution of the lead institution, all covered bond investors should have direct recourse to all cover pool assets and a residual claim against the lead institution. Member states may however specify additional rules that regulate the remaining claim of investors against the credit institutions that contributed to the joint funding of the cover pool if the insolvency estate of the lead institution is insufficient. Jointly funded covered bonds should be subject to all applicable covered bond rules and covered bond public supervision.

One joint funding model would indeed enhance transparency

We tend to agree with the ECON that **intragroup pool and external joint funding proposals should best be integrated in one single proposal for joint funding**, whether group internal or external. This would indeed support transparency and simplify the joint funding language of the Directive proposals. We also agree with the ECON's point of view that the coverage of intragroup and external joint funding by the same article and set of rules enhances the level playing field between small banks that belong to a group large enough to issue covered bonds versus those that do not. Furthermore, we believe this also removes some of the question marks we had with the Directive's proposals regarding the regulatory coverage of the internally issued covered bonds versus the covered bonds externally issued.

The cross-border joint funding implications remain unclear

Having said that, **the cross-border group funding implications remain somewhat unclear** in our view. One of the potential consequences of introducing the joint funding option for large banking groups is that instead of establishing different covered bond programmes by different issuing entities across jurisdictions, this may instead support issuance by one group lead institution located in the country with the most favourable regulatory or funding cost features. However, given the fact that the asset eligibility criteria of the Directive would be applicable, the options for joint funding that would involve inclusion of assets outside the EEA may be more complicated. Namely member states may or may not allow for inclusion of assets located outside the Union (or EEA). Under the Directive's proposals, in order to do so, they would have to make sure that the realisation of these assets is legally enforceable in the same way as EU assets. Furthermore, in the case of group funding that stretches beyond national borders, group participants may on a standalone basis also be subject to supervision by different supervisory authorities, which may make cross-border group funding more complex.

4) Overcollateralization requirements

Little clarification on question marks to overcollateralization requirements

Question marks regarding overcollateralization calculations remain

As we explained in our comment on the Directive and Regulation proposals in April (see *European covered bond rules/Strengthening conditions for preferential treatment*), the Directive and Regulation leave a number of **question marks to how the required 5% overcollateralization level should** actually **be calculated**, for instance a) with reference to the denominator (covered bonds outstanding versus total liabilities) or b) to the application of LTV cut-off percentages against a backdrop of a 100% coverage requirement and 5% nominal overcollateralization requirement. The ECON's amendment proposals provide limited additional clarity in this regard.

The ECON believes that other than nominal calculation principles should not result in a higher level of coverage

As a matter of fact, the ECON introduces one amendment that seems to water down the Directives collateralization requirements. The Directive's collateralization requirements stipulate that the assets in the cover pool should cover all covered bond liabilities, including the obligations for payment of principal plus accrued interest of the covered bonds outstanding and costs related to the maintenance and administration of the covered bond programme. The ECON adds here that member states may allow for a lump sum calculation of costs related to the maintenance and administration of a covered bond programme. The calculation of the level of coverage furthermore requires that the nominal amount of assets in the cover pool is at least equal to the nominal amount of covered bonds outstanding. Under the Directive proposals member states may allow for other calculation principles if these would not result in a ***lower*** level of coverage than calculated under the nominal principle. The ECON, on the other hand, seems to take the view that other principles of calculation should not result in a ***higher*** level of coverage than calculated under the nominal principle. This, in our view, seems an odd amendment, considering that it actually prohibits stricter collateralization requirements than calculated under the nominal principle.

Exposure limits should also be taken into consideration for overcollateralization purposes

Exposure limits should be taken into consideration for overcollateralization purposes

The European Commission's Regulation proposals for a 5% minimum overcollateralization state that assets contributing to the minimum overcollateralization level should not be subject to the **20% limit on non EEA public sector exposures** or to the **15% restriction on exposures to institutions** and as such will not count towards these limits. However, in the ECON's view these proposals conflict with the EBA's recommendation made in 2016. These limits **should be taken into consideration for overcollateralization purposes**. Otherwise, the cover pool assets used to meet the overcollateralization requirements could include a larger amount of lower quality exposures than considered desirable as eligible assets, which could create financial stability risks in the ECON's view.

5) Asset eligibility and reporting

CQS1 waiver with respect to Article 129 1(c) should be temporary

The ECON proposes to make the waiver with respect to Article 129 1(c) a temporary waiver...

While the European Commission's Regulation proposals make the eligibility of exposures to credit quality step (CQS) 2 rated institutions permanent, the ECON proposes that **the waiver with respect to Article 129 1(c) should only be temporary**.

The current Article 129 1(c) of the CRR stipulates that exposures to credit quality step (CQS) 1 (i.e. AA- or better) rated institutions are allowed up to 15% of the covered bonds outstanding. Exposures to credit institutions within the EU with a maturity not exceeding 100 days can be CQS2 (A-) or better rated. The CRR gives competent authorities the option to partially waive these requirements by allowing A- or better rated exposures to institutions up to 10% of the covered bonds outstanding upon consultation by the EBA. **This waiver is only applicable if significant potential concentration problems can be documented** due to the application of the credit quality step 1 requirement.[2]

....where the Regulation proposals make the CQS1 waiver permanent

The European Commission's **Regulation proposals advocate a more permanent solution**. Under the Regulation proposals exposures to credit institutions that qualify for credit quality step 1 or 2 are eligible for as long as a) CQS1 exposures do not exceed 15% of the nominal amount of the covered bonds outstanding, b) CQS2 exposures do not exceed 10% of the nominal amount of covered bonds outstanding, and c) the aggregate of CQS1 and CQS2 exposures do not exceed 15% of the covered bonds outstanding.

The ECON, on the other hand, states that even though it may be increasingly difficult to find CQS1 rated credit institutions**, legislation should not enter a race to the bottom with credit institutions**. For that reason, the ECON believes that the EBA should only in times of stress **temporarily, i.e. for a period of three years**, waive the application of the CQS1 rating requirement and allow CQS2 rated exposures up to 10% of the outstanding covered bonds of the issuing institution. The ECON argues that the credit quality standards should be upheld and considers it the task of the credit institution to adapt and re-establish their creditworthiness to the highest level.

[2] The EBA assesses this by taking among other things into account factors such as a) the nature and magnitude of exposures to credit institutions assumed by covered bonds in a jurisdiction, b) the number of credit institutions with a credit quality step 1 rating in a jurisdiction and the scope of business activities of these credit institutions, c) other potential jurisdiction-specific considerations related to credit institutions, or potential additional eligibility considerations of covered bond regimes on exposures to credit institutions beyond the credit quality step 1 criterion, and d) the expected impact of granting or not granting the partial waiver. Countries such as Germany, Denmark, Sweden and Poland have all received positive opinions by the EBA on the use of this partial waiver.

We favour the Parliament's permanent solution

Although we can understand the ECON's point of view that high credit quality standards should be upheld, **we believe that potential counterparty concentration issues outweigh the "race of the bottom" argument of the ECON**. Particularly so considering that lower counterparty quality considerations are already partly accounted for by capping the CQS2 exposures at 10% rather than 15% of the covered bonds outstanding. The years after the credit crisis and sovereign debt crisis have, in various instances, also proven to be lengthy in terms of rating recoveries, stretching beyond three years.

There is still no regulatory clarity to what exposures to institutions comprise

Furthermore, **neither the Regulation proposals, nor the ECON's amendment proposals take a clear stance on whether derivatives should or should not be exempted** from Article 129 1(c). In the past the EBA has argued that exposures arising from the use of account bank facilities, from derivative contracts entered into with credit institutions, or from the use of instruments issued by credit institutions as substitution assets are examples of Article 129 1(c) exposures. The ECBC has subsequently provided the EBA with a number of reasons why Article 129 1(c) should not apply to derivatives. These included the warning that protection given to covered bonds by derivatives would be at risk if the 15% limit would be exceeded due to swap volatility, while at the same time concentration risks to institutions eligible as derivative counterparties would be extremely high given that there are not many EU institutions that are CQS1 rated. Up until today there is no regulatory clarity on this matter.

Immovable property of non-profit organisations included as distinct asset class

The ECON proposes to separately mention non-profit organisations property loans

The ECON also proposes to include a separate reference **to immovable property of non-profit organisations**, such as churches, museums or hospices. The ECON clarifies that this category of property loans is both non-commercial and non-residential. To this purpose it proposes that loans secured by commercial immovable property, or by non-residential immovable property held for non-profit purposes, should separately be mentioned as eligible cover assets up to a loan-to-value ratio of 60%.

In our view, even though non-profit organisations may be non-commercial, it is should be relatively straightforward that these property loans are, in terms of characteristics, closer aligned with commercial real estate than residential real estate. Making a separate distinction may also raise the question whether more clarity should be warranted, for instance, with respect to houses with additional work facilities, etc.

A bi-annual rather than quarterly reporting requirement

A six month reporting requirement is sufficient in the ECON's view

With respect to the Directive's proposal to provide investors with information on a quarterly basis, the ECON reiterates that **semi-annual information provision should be sufficient** as a minimum standard as this is also the current requirement in Article 129 (7) of the CRR. In our view, given that the majority of covered bond issuers already report at least on a quarterly basis, a quarterly reporting standard seems from a transparency point of view more appropriate to facilitate ongoing monitoring and risk management by investors. It is indeed true that Article 129 (7) currently provides for a six month information requirement. This requirement is also part of the LCR level 1 and 2a eligibility criteria for covered bonds. Having said that, the level 2b LCR eligibility criteria already require issuers to make the information referred to in CRR Article 129 (7) available on a quarterly basis, while disclosure on the 10% overcollateralization requirement should even be disclosed on a monthly basis. In its harmonization proposals the EBA also recommended a quarterly reporting standard. Furthermore, since 1 July 2017 the ECB also requires that rating agencies publish their surveillance reports on covered bonds on a quarterly basis.

No loan-by-loan information

At the same time, the ECON is of the view that **member states should not be given the option to require information provision on a loan-by-loan basis** as the flood of information would probably not be processed by investors. In its harmonization proposals the EBA suggested that loan-by-loan information provision may be appropriate for conditional pass-through covered bonds. Therefore, rather than simply subjecting conditional pass-through covered bonds to higher risk weights it may deserve further consideration whether additional loan-by-loan information would indeed provide additional risk management assurance for these covered bonds. Having said that, conditional pass-through covered bonds are a dual recourse instrument and no securitization notes. In a pre-insolvency situation the timely payment of interest and redemptions on the covered bonds is the issuer's responsibility and not related to the (re)payment of the cover assets. The pool of assets securing the covered bonds is also in principle dynamic and not static, which may make the full processing of loan-by-loan information on every single reporting date a far more complex task for investors than in the case of the static pools of assets securing securitization notes.

6) Third country equivalence

Urging to step up on third country equivalence

The EC should not wait for three years before publishing a third country equivalence proposal

The ECON is of the opinion that the European Commission's proposal to wait for more than **three years before** possibly **submitting a legislative proposal for third-country equivalence** recognition is **at odds with** the Parliament's **objective of establishing** an EU covered bonds framework that serves as **a benchmark** for developing covered bond markets worldwide. A delay in this field would, in the ECON's view, signal a reluctance to open the EU market to non-EU credit institutions.

The Commission's framework is sufficient to provide for a third country equivalence opinion

The ECON believes the Commission's harmonisation **framework is sufficient to allow for an equivalence assessments** of similar measures enacted by third countries. The ECON argues that even if such an equivalence regime is introduced now, equivalence would not necessarily have to be granted to third countries immediately. It would simply provide a framework based on which equivalence can be granted if the European Commission were to decide that these third countries provide equivalent levels of investor protection.

Third country equivalence should be assessed based upon the Directive's requirements...

Therefore, the ECON proposes to amend the Directive proposals to clarify that the Commission can adapt **delegated acts supplementing the Directive** by determining that the legal supervisory and enforcement arrangements of a third country are:

- **equivalent to the Directive's requirements** on the structural features of covered bonds and covered bond public supervision, and
- are effectively **applied and enforced in an equitable and non-distortive manner** in order to ensure effective supervision and enforcement in that third country.

Where the Commission has adapted a delegated act on a third country's equivalence, a covered bond issued by an issuer established in that third country should be deemed to have met the Directive's requirements on the structural features of covered bonds.

Third country equivalence should be subject to ongoing monitoring

The ECON also proposes that the European Commission should, in cooperation with ESMA, **monitor** the effectiveness of arrangements of equivalent third countries and report regularly to the European Parliament and the Council on this. If there would be an insufficient or inconsistent application of the arrangements by third country authorities or a material regulatory divergence by that country, the European Commission may consider **withdrawing the equivalence recognition** of the third country's legal framework. In that case, the European Commission has to set forth a transparent procedure governing the withdrawal or suspension of the equivalence decision, to avoid market uncertainty and support financial stability.

We support the ECON's proposals to provide for a third country equivalence assessment at an earlier stage

We agree with the ECON that the Commission has sufficient ammunition available to establish third country equivalence proposals at an earlier stage than three years from the date the Directive enters into force. **Clarity on the third country equivalence** rules under EU law would indeed provide regulators outside the EU with a **valuable** and detailed guidance on the minimum requirements for preferential treatment within the

EU. This would be supportive to regulatory developments across the globe, even if the European Commission were to wait until 1 January 2022 before granting equivalence treatment. On that that date preferential treatment for covered bonds on a global level under the Basel III reforms is expected to become effective. This would, in turn, also provide for the preferential treatment of EEA covered bonds outside the EEA.

7) Public supervision

Stick to principles based public supervision requirements on penalties

The Directive proposals are very detailed on the chapter of public supervision

The ECON recognizes that for a principles based framework, the European Commission's **Directive proposals are very detailed on the chapter of covered bond public supervision**, particularly in the field of sanctioning. The Directive establishes requirements for permission to issue covered bonds, describes the role of competent authorities in the event of insolvency or resolution, provides for issuer reporting requirements vis-à-vis the competent authorities, and details the powers of the competent authorities for the purpose of covered bonds public supervision, including its authority to impose administrative sanctions or remedial measures.

The ECON proposes to leave sanctioning details to the discretion of member states

We consider the introduction of such detailed guidance to what covered bond special public supervision should entail an important and valuable section of the Directive. Having said that, we agree with the ECON that **the amount of detail, particularly on sanctions and remedial measures, is stretching beyond principles based**. For that particular reason, we support the ECON's proposals to remove details on what penalties and measures should include from the Directive to leave this to the discretion of national regulators. The same holds for the proposed removal of the detailed circumstances in the Directive to be taken into consideration when determining the type of administrative penalties or remedial measures or the amount of those penalties. Also the publication requirements for the administrative sanctions and remedial measures should, in the ECON's view, be fully removed from the Directive. The ECON clarifies that the Directive should merely assure that penalties and remedial measures are effective, proportionate and dissuasive.

Appendix 1

Drafting the eligibility criteria for ordinary covered bonds

The ECON proposes to essentially replace the Directive's Article 6 on eligible assets by a separate article 6 for **CRR eligible premium covered bonds** and 6a describing the asset **eligibility criteria for ordinary covered bonds**. The asset eligibility criteria require that covered bonds are at all times secured by high quality cover assets, including those assets referred to as eligible in Article 129(1) (a) to (g) of the amended CRR for preferential treatment of covered bonds (premium covered bonds).

Under the proposed article 6a member states may also allow for the issuance of covered bonds secured by high quality assets not referred to as eligible in CRR Article 129(1) (a)-(g). In this case the cover assets have to provide the credit institution that issues the covered bonds a) with **claims for the payment** of a clearly determined amount and b) secured by **collateral assets** that meet the specified minimum criteria. The choice of the cover assets, furthermore, has to **mitigate certain risks**.

Claims for payment

The **claim for payment** has to meet the following legal requirements:

Claims are collateralised by registered assets or are an eligible public undertaking

- Each claim is collateralised by assets for which a **public register records ownership** and collateral risks, or is a loan to an eligible **public undertaking**;
- Each claim is secured by a legally established mortgage, charge, lien or other guarantee and each of these is **enforceable**;
- The mortgage, charge, lien or guarantee securing the claim enable credit institutions issuing covered bonds to receive the payments of the claim in due time and a reasonable cost.

Member States have to specify rules ensuring the prompt filing or registration of mortgages, charges, liens or guarantees on the claims in the cover pool. They also have to ensure that credit institutions issuing covered bonds assess both the enforceability of the claims and the expected length of legal proceedings before including such in claims in the cover pool.

Collateral assets

The **collateral assets** have to meet one of the following requirements:

Physical assets should be valued

- For ***physical assets***, either the **market value** or the **mortgage lending value** can be determined or, if this is not possible, the asset is valued by rules laid down by the Member State. The collateral physical asset is valued by an independent valuer. Member States furthermore have to specify a valuation methodology and a process designed to yield values which are equal to or less than the unknown market or mortgage lending value of an asset at the moment of inclusion in the cover pool;

Counterparty exposures should be sufficiently safe and sound

- For ***assets in the form of exposures to a counterparty***, the counterparty's safety and soundness is inferred from its tax-raising powers or from being subject to either public supervision or an ongoing credit assessment by an independent professional third party, such a rating by a nominated ECAI.

Risk mitigation

The **risk mitigation** has to be ensured by the following requirements:

- All collateral for cover pool assets have to be adequately **insured** against the risk of loss or damage and the claim out of the insurance has to be part of the substitution assets of the cover pool;

Physical assets can be included up to an LTV of 60%...

- ***Physical assets*** can serve as collateral for cover pool claims for at most 60% of their value (i.e. up to an LTV of 60%);
- ***Assets in the form of exposures to a counterparty*** are eligible at a discount rate versus their nominal amount and not exceeding:

- **90%** of the exposure in the case the counterparty has **tax raising powers**;
- **80%** of the exposure if the counterparty is under **public supervision**;

...., while unguaranteed IG rated exposures should be recognized up to 60% of the nominal value

- **60%** over the exposure in the case the counterparty is subject to an ongoing **credit assessment** by an independent professional third party (including a nominated ECAI) and is at least investment grade rated.

Cover pools should be sufficient granular with limited obligor concentration

- The cover pool assets have to be sufficiently granular to enable risk diversification. This means that the cover pool contains **at least 500 exposures**, loans or other types of claims, all of which have some degree of idiosyncratic risk.
- The cover pool also has to be free of material concentration risk, meaning that the aggregate **exposure to a single obligor shall not exceed 2%** of the nominal cover pool value.

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