Covered Bond Investors Council (CBIC)

AMIc CBIC response to European Commission Consultation Document: Covered Bonds in the European Union (30 September 2015)

Introductory comments

The International Capital Market Association’s (ICMA) Asset Management and Investors’ Council (AMIC) runs a Covered Bond Investors Council (CBIC). AMIC was established in March 2008 to represent the buy-side members of the ICMA membership. ICMA is one of the few trade associations with a European focus having both buy-side and sell-side representation.

The AMIC composition embraces the diversification and the current dynamics of the industry – representing the full array of buy side interests both by type and geography. The AMIC’s focus is on issues which are of concern to its broad membership, rather than having a specific product focus.

The CBIC is a permanent working group of AMIC. The CBIC represent around 30 investors, including asset managers, insurers, pension funds and bank treasuries, interested in the European covered bond market. The CBIC promotes high quality, simple and transparent covered bonds. Improving transparency is viewed as essential for the market and to make it possible for investors to compare different covered bond programmes.

CBIC members wish to make a general observation about this process not specific to any of the individual questions.

The CBIC and its members welcome the opportunity to comment on this consultation paper and to contribute to the discussion on the development of this important asset class. Covered Bonds represent a unique asset class with peculiar characteristics emanating from specific national laws built around it, unlike other fixed income asset classes. The financial services industry has committed significant resources over many years to create covered bond standards in EU and non-EU countries. Whichever option the European Commission chooses to pursue to harmonise markets, the Commission must be careful not to needlessly disrupt a well functioning market given the history of the asset class.

Also, the premise of the economic analysis section of the consultation paper could be paraphrased as saying that the extreme convergence of covered bond spreads before the crisis became the norm and that subsequent events point to a sub-optimal fragmentation of markets within the European Union.

However, it could be argued that markets prior to 2007 had fundamentally mispriced risks inherent in the securities and that a return to that condition is not necessarily a desirable outcome. Particularly in the absence of implicit state support for the banking system, different covered bonds do reflect different underlying risk characteristics and it is the job of the market to identify and price these risks appropriately.
A regulatory response from the European Commission should only seek to eliminate those risk characteristics which are a function of differences between regimes in Member States, not risks that are a function of, for example, different underlying risk characteristics of the assets or different commercial models. A market where all covered bonds price at the same level independent of issuer specific and asset specific risk factors is neither a practical nor a desirable outcome of this process.

**PART I - COVERED BOND MARKETS: ECONOMIC ANALYSIS**

Questions 1 and 2

1. In your opinion, did pricing conditions in European covered bond markets converge and diverge before and after 2007, respectively? If so, what where the key drivers of this convergence/divergence? Please, provide evidence to support your view.

2. Was pricing divergence an evidence of fragmentation between covered bonds from different Member States? Do you agree with the reasons for market fragmentation described in section 2.1 of Part I? Were there any other reasons?

The observed spread divergence and subsequent convergence within the covered bond market was evidence of fragmentation between markets, not between different classes of covered bonds per se. On the contrary the strength of covered bond regimes in many distressed countries, for example in Spain or Portugal, was a mitigant to the effect of widening sovereign risk premia in those countries.

Reasons for the greater yield that investors required to hold covered bonds during the height of the crisis included: i) the low but real possibility that the country in question might be forced to exit the euro system with uncertain but obviously negative consequences being forced onto covered bonds, ii) the probability of default of the issuing bank, iii) the probability of default of the sovereign and iv) the more attractive relative value available as a result of the widening of spreads in related markets.

CBIC members did not observe weaknesses in covered bond regimes per se as a reason for spread widening.

**Question 4**

4. Is there an appropriate alignment in the regulatory treatment between covered bonds and other collateralised instruments? If there is a misalignment, could you illustrate what differences in regulatory treatment you deem as inappropriate and why?

There is broad sympathy for relatively better capital treatment, particularly in Solvency II, for prime Residential Mortgage Backed Securities (RMBS) and recognition of the work being undertaken currently on STS securitisations.

**Question 6**

6. Are there significant legal or practical obstacles to:
   a) cross-border investment in covered bond markets within the Union and in third countries; and
   b) issuance of covered bonds on the back of multi-jurisdictional cover pools?

**Question 6a**
By far the largest barrier to cross border investment is client investment mandates. There are few or no material structural constraints although occasionally there may be withholding tax problems, or difficulty for some investors to invest in high quality covered bonds that do not meet their regulatory needs, for example due to being issued outside the EEA.

**Question 6b**

Although this question is primarily for issuers, CBIC has strong doubts about the desirability of cross-border cover pools. There is a preference for covered bonds (and therefore individual cover pools) to comprise assets from only one country and for issuers not to have a ‘free option’ to change the national composition of the asset pool over time. CBIC members are satisfied with the approach currently adopted by banks with operations in more than one member state (such as Nordea, Danske, Unicredit or Santander) who operate separate programmes in each of their countries of operation.

Full transparency of the current geographical distribution of the cover pool is only a very limited mitigant of this risk due to the revolving nature of the cover pool.
PART II - EXPLORING THE CASE FOR A MORE INTEGRATED FRAMEWORK

Question 1

1. Would a more integrated "EU covered bond framework" based on sound principles and best market practices be able to deliver the benefits suggested in section 2 of Part II? Are there any advantages or disadvantages to this initiative other than those described in section 2 of Part II?

CBIC wishes to emphasise that whereas there are potential benefits from a more integrated EU covered bond framework, the European Commission should be careful not to water down existing strong national frameworks, and should be mindful of the long and successful history of the asset class and the market consensus and recognition which it currently enjoys.

Further, the CBIC believes that the stability of legal frameworks is essential. A covered bond law should not introduce a change that would lower any single constraint on existing covered bonds: e.g. if there is a high minimum overcollateralisation requirement, this should not be lowered. Changes can be made to the laws for new covered bonds, but not for existing ones.

There can be no balance between different measures either. For example: to reduce the overcollateralisation requirement but to compensate with a better liquidity stress test would not be acceptable.

Covered bonds are in general long term investments (5, 10 or 20 years) based on a specific framework. Creating new laws is a possibility but existing covered bonds should never be weakened in any single aspect.

Question 2

2. In your view, are market-led initiatives such as the "Covered Bond Label" sufficient to better integrate covered bond markets? Should they be complemented with legislative measures at Union or Member State level?

CBIC members strongly support market-led initiatives, including both the Covered Bond Label and the Harmonised Transparency Template (HTT). Although the disclosure standards in the latter still fall short of the CBIC’s own requested data template it does represent a very significant step forward for the market.

Some CBIC members comment that market initiatives could only succeed for the entire market with further help from regulatory bodies.

Question 3

3. Should the Commission pursue a policy of further legal/regulatory convergence in relation to covered bonds as a means to enhance standards and promote market integration? If so, which of the options suggested in section 3 of Part II should the Commission follow to that end and why?

Some CBIC members prefer Option 1, arguing that voluntary non-legislative based measures would inevitably be adopted by national supervisors due to market forces. This is already occurring in many countries with the adoption of the EBA best practice guidelines by national level supervisors. The
adoption of investor side rules, such as capital benefits that refer to these guidelines, would only enhance the convergence.

Other CBIC members consider that anything which exists on a purely voluntary basis would effectively be too weak. Although it is recognised that national specificities and the current balance of competencies between the EU and Member States means that an overly prescriptive regime would be impractical it is felt that a combination of Option 1 and a directive specifying strong minimum standards would be more effective.

Direct harmonisation via a 29th regime is highly impractical.

As a general observation, CBIC believes that the consultation paper contains too little information on the details of the two options for investors to make firm judgements at this stage.

**Question 8**

8. Would you view a combination of recommendations to Member States (Option 1) and targeted harmonisation of certain minimum standards (Option 2) as desirable and sufficiently flexible? If so, what should be the subject of each option?

More detailed definitions of the proposed high level elements are needed before a meaningful decision can be made on this point. Further market dialogue is required. As stated earlier, some members preferred Option 1 and others Option 2, i.e. a combination of a recommendation and targeted harmonisation, but CBIC believes that the consultation paper contains too little information on the details of the two options for investors to make firm judgements at this stage.
PART III - ELEMENTS FOR AN INTEGRATED COVERED BOND FRAMEWORK

Section 1 – Covered Bond Definition

Question 1

1. What are your views on the proposals set out in section 1 of Part III for a "new legal definition" of covered bonds to replace Article 52(4) of the UCITS Directive?

The different definitions of covered bonds which currently exist in different investor regulations and directives should be brought into line wherever possible.

The CBIC supports the proposal to drop the ‘EEA-only’ criteria in UCITS 52(4) as long as certain conditions are met including i) that ‘equivalence’ includes a requirement for the non-EEA country to conform to the EBA’s best practice guidelines, ii) comparability of the underlying assets with those defined in CRR 129(7) and iii) ease of valuation.

Given the distortion of the market caused by the ECB’s covered bond purchase programme, this would help to ameliorate both the shortage of bonds currently and the relative value anomalies.

A minimum credit standard or further geographical limitations would not be appropriate. So for example ‘emerging markets’ covered bonds should be eligible for inclusion subject to the quality of the covered bond regime and supervision.

Some CBIC members have stated that there is currently a weakness in the definition of the dual recourse in certain cases: if the recourse to the cover pool is clear, the recourse to the bank is not. Indeed in the case of an SPV issuing covered bonds, the current existing definition of a covered bond implies a recourse on the issuer but not on the parent company (the bank). As investors we need a genuine recourse on the bank and not just on the SPV/issuer since the SPV does not provide any protection except the cover pool.

Section 4 – The Cover Pool

Section 4.1 Eligible assets: qualifying criteria and requirements

Sub-Section – Residential and commercial loans

Question 1

1. Do you agree with the proposed definitions for "residential" and commercial loans" as cover assets? Should certain riskier residential or commercial loans (ie buy-to-let mortgages; second home loans; loans to real estate developers; etc.) be excluded from the cover pool or permitted subject to stricter criteria?

Full transparency regarding the nature of the assets in the pool and the contractual and legal limitations on the definition of residential and commercial loans is more important than any given set of rules on eligibility. However, CBIC members do have some specific opinions on some of the topics in this section.

Loans in arrears should not be eligible for inclusion at the inception of the transaction. Furthermore, in the case of insolvency or resolution they should remain in the pool for the benefit of covered
bond creditors but that in the normal course of business they should be assigned a zero value for the purposes of, for example, conformity with statutory tests.

Question 3

3. In relation to LTVs:
   a) what are your views on the proposals set out in subsection 4.1 of Part III on minimum LTVs?
   b) in the case of insured properties, should higher LTV limits be allowed if the insurance cover meets certain requirements and, if so, what should such requirements be? In what other cases should higher LTV limits be allowed? Could loan-to-income requirements be used to replace or complement LTV limits?
   c) should there be an additional average LTV eligibility limit at portfolio level?
   d) with the advent of a Binding Technical Standard defining Mortgage Lending Value, is it appropriate to apply this for eligibility in all cover pools across the Union as a prudent measurement?
   e) should LTV limits be used to determine: eligibility (loan in/out) of loans at inception? Eligibility (loan in/out) of loans on an ongoing basis? Should they instead be used to simply determine contribution to coverage? A combination of the above?

The CBIC supports the EBA’s guidelines on minimum LTVs.

Most CBIC members believe that it is impossible to agree a common basis for valuation (market value or mortgage lending value) but that market value should be the minimum standard with supervisors in Member States at liberty to apply higher standards where appropriate.

Question 4

4. In relation to the valuation of cover assets:
   a) how frequently should the value be updated and in which way (revaluation, update of the initial valuation, and in which way)?
   b) what criteria should be applied to (i) the valuer and (ii) the valuation process to ensure that they meet the transparency and independence principles set out in the first and second subparagraphs of Article 229(1) CRR?

The rules on valuation for cover pool purposes should be conformed to the existing valuation rules in Article 208 of the Capital Requirements Regulation (CRR).

Sub-Section – Public sector assets

Question 1

1. What are your views on the proposals for public sector loans as cover assets set out in subsection 4.1 of Part III?

The CBIC agrees with the proposals for eligible assets contained in this section.

Sub-Section – Other assets

Question 1
1. Should the Framework exclude aircraft, ship and SME loans from cover pools or should they be allowed only subject to strict criteria and limits? If so, what criteria and limits should be applied?

One group of CBIC members believe that given the niche nature of the ship and aircraft segments, regulatory recognition of this asset class is not economically necessary. Furthermore, given the nature of the underlying credits there is little support for their continued inclusion as eligible assets.

Other CBIC members believe that ship mortgage backed covered bonds should continue to be eligible collateral.

Similarly loans to small and medium sized enterprises (SMEs) were felt to potentially dilute the nature of the asset class and it was felt that other funding instruments were more appropriate sources of funding for them.

Section 4.2 – Coverage requirement and overcollateralisation

Coverage requirement

Question 1

1. Which option should be preferred for the Framework to formulate the coverage requirement and why?
   a) a general requirement along the lines of Article 52(4) of the UCITS Directive, amended to include the wording suggested by the EBA;
   b) a nominal coverage;
   c) a net-present value coverage;
   d) a net-present value coverage under stress; or
   e) any other or a combination of the some or all of the above.

The basis on which coverage requirements should be specified should depend on national specificities. The inclusion or exclusion of stress tests in the coverage requirements might create a ‘double count’ if regulators were also to apply additional coverage buffers on a pool-by-pool basis.

Having said this, some members express a preference for a nominal basis as a starting point.

Overcollateralisation

Question 1

1. Should a quantitative mandatory minimum OC level be set in the Framework? If so, what should that level be and should it be the same for all types of covered bonds?

A firm decision on the nature of minimum over-collateralisation levels is impossible currently given other areas of uncertainty in the consultation paper.

However the level for pool specific buffers is something which should be decided by national supervisors based on local specificities. Furthermore, the model of a legal minimum level for all issuers plus a pool specific, regulator decided buffer of extra overcollateralisation is appropriate. Finally, ‘voluntary’ or contractual over-collateralisation should be strongly protected by regulations and supervisors.
All forms of over-collateralisation should be specified relative to the basis which is appropriate in that Member State (see previous answer).

Question 3.

3. Should the framework set a maximum level of permitted OC? If so, when and at what level?

A maximum OC in case of insolvency would be a major threat to the asset class and should be avoided.
SECTION 5 – TRANSPARENCY REQUIREMENTS

Questions 1 to 7

QUESTIONS – TRANSPARENCY REQUIREMENTS
1. What are your views on the current disclosure requirements set out in Article 129(7) of the CRR? If more detailed requirements were preferred, do you agree that issuers should disclose data on the credit, market and liquidity risk characteristics to a more granular level? If so, what data and to what level of granularity?
2. Should issuers disclose information on the counterparties involved in a covered bond programme and, if so, what type of information?
3. How frequently should covered bond issuers be required to make disclosures to investors?
4. What are your views on the existing and prospective investor reporting templates prepared by industry bodies and referred to in section 5 of Part III? Would these templates:
   a. be granular enough to enable investors to carry out a comprehensive risk analysis as recommended by the EBA?
   b. be sufficient without further legislative backing to deliver enhanced and consistent disclosure in European covered bond markets?
5. Should detailed disclosure requirements apply to all European covered bonds or only to those that would fall within the scope of the Prospectus regime?
6. Should the same level of disclosure standards apply pre- and post-insolvency/resolution of the issuer (except for those reporting items referring to the issuer itself)?
7. In relation to covered bonds issued in third countries, what minimum level of disclosure should apply for European credit institutions investing in those instruments to benefit from preferential risk weights?

As previously noted CBIC strongly supports the ECBC’s Harmonised Transparency Template (HTT). As a minimum this should become accepted as market standard and ideally should be referenced by the Best Practice guidelines.