



EBA/Op/2014/04

1 July 2014

Opinion of the European Banking Authority on the preferential capital treatment of covered bonds

Introduction and legal basis

The EBA competence to deliver this Opinion to the European Commission is based on Article 34(1) of Regulation (EU) No 1093/2010¹.

Article 503(1) of Regulation (EU) No 575/2013 ('Capital Requirements Regulation' - CRR) provides that the EBA be consulted by the Commission on whether the risk weights laid down in Article 129 and the own funds requirements for specific risk in Article 336(3) are adequate for all the instruments that qualify for these treatments and whether the criteria in Article 129 are appropriate. Article 503(3) of the same regulation provides that the EBA be consulted by the Commission on whether loans secured by aircrafts (aircraft liens) and residential loans secured by a guarantee but not secured by a registered mortgage, should under certain conditions be considered an eligible asset in accordance with Article 129.

The EBA has received a call for advice from the Commission further specifying the above mentioned mandates and requesting the EBA to provide advice also on the appropriateness of the preferential treatment of internally originated mortgage backed securities, as referred to in the derogation established by Article 496 of the CRR.

In accordance with Article 14(5) of the Rules of Procedure of the Board of Supervisors², the Board of Supervisors has adopted this opinion.

¹ Regulation (EU) No 1093/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Banking Authority) amending Decision No 716/2009/EC and repealing Commission Decision 2009/78/EC (OJ L 331, 15.12.2010, p. 12).

² Decision adopting the Rules of Procedure of the European Banking Authority Board of Supervisors of 11 December 2013 (Decision EBA DC 001 (Rev3)).

Proposals of the Opinion

This Opinion constitutes the advice of the EBA on several aspects related to the preferential capital treatment of covered bonds specified in Article 129 of the CRR.

The 'EBA Report on EU covered bonds frameworks and capital treatment' (the Report), accompanying this Opinion, develops the analysis which was carried out to support the different recommendations.

The advice takes the form of:

- One recommendation on the overall appropriateness of preferential capital treatment specified in Article 129 of the CRR;³

Recommendation: EU COM 1 – Risk weight preferential treatment of covered bonds

Due to the good historical default/loss performance of covered bonds in the EU, the dual recourse principle embedded in covered bond frameworks whereby the covered bond holder has a claim on the issuing institution and a priority claim on the cover assets, the special public supervision for the protection of the bondholders mandated by the UCITS Directive and the existence of qualifying criteria in Article 129 of the CRR, the EBA considers the preferential risk weight treatment laid down in Article 129 of the CRR to be, in principle, an appropriate prudential treatment.

In relation to the criteria mandated by Article 129 of the CRR which determine which asset classes currently qualify for preferential treatment, the EBA only expresses prudential concerns over the derogation foreseen for own originated securitisation units, as elaborated upon in Recommendation EU COM 2 – C.

While Article 129 of the CRR sufficiently elaborates on the eligibility of asset classes, it is less specific on equally relevant aspects of safety of the covered bond. The EBA considers that further consideration should be given to the opportunity of complementing the qualifying criteria mandated by Article 129 of the CRR to cover, at a minimum, the areas of liquidity risk mitigation, over-collateralisation and the role of the competent authority, and the further elaboration of existing requirements on disclosure to investors, as outlined in the Recommendations EU COM 1-A to 1-D.

In addition, the EBA considers that in the longer term:

- Further convergence of national legal/regulatory and supervisory covered bond frameworks should be achieved, so as to further support the existence of a single preferential risk weight treatment to covered bonds in the EU.
- The appropriateness of preferential risk weight treatment should be monitored due to developments in asset encumbrance levels as well as the evolution of the overall credit quality and dual recourse properties of covered bonds after the entry into force of the Bank Recover and Resolution Directive.

³ Recommendation EU COM1 can be found in Chapter 10 of the Report.

- Four recommendations on additional/complementary criteria to qualify for preferential capital treatment;⁴

Recommendation EU COM 1 - A: Legal/regulatory over-collateralisation

The EBA considers that a legal/regulatory minimum over-collateralisation level should be considered for inclusion among the qualifying criteria determining preferential risk weight treatment. The formulation of a quantitative legal/regulatory minimum over-collateralisation requirement would require further analysis as it depends on several factors, including but not limited to, the class of cover assets as well as, crucially, the chosen coverage principle among the several different coverage principles currently adopted across jurisdictions (nominal, net present value, net-present value under stress, etc.).

Recommendation EU COM 1 - 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 total net out-flows of the covered bond programme over a certain time frame, should be considered for inclusion among the qualifying criteria determining preferential risk weight treatment. Determining the calibration and scope of such a requirement would require further analysis since, as the report acknowledges, different structures of the covered bond programme - e.g. hard bullet, soft bullet and conditional pass-through structures - expose to different extents the covered bond investor to liquidity risk.

Recommendation EU COM 1 - C: Role of the competent authority

The EBA considers that requirements relating to the role of the special public supervision of the covered bonds should be considered for inclusion among the qualifying criteria determining preferential risk weight treatment. The requirements considered for inclusion may cover: i) supervision prior to the issuance of covered bonds, ii) ongoing supervision and iii) supervision post-default/resolution of the issuer.

Recommendation EU COM 1 - D: Disclosure to covered bond investors

Article 129(7)(a) includes provisions on the information that covered bond investors must receive from the issuer to seek the risk weight preferential treatment on their covered bond investment. The EBA recommends that the disclosure criteria included in Article 129(7)(a) be further clarified by means of binding technical standards. In addition, the scope of those standards should allow for the possibility of extending the disclosure criteria included in Article 129(7)(a) to include additional variables, depending on further analysis to be developed when drafting the standards

- Three recommendations on the appropriateness of including specific classes of cover assets in the scope of the preferential capital treatment, as specified in Article 129 of the CRR.⁵

Recommendation EU COM 2 - A: Loans secured by aircraft liens

Based on the qualitative and quantitative evidence included within this report the EBA considers

⁴ Recommendations EU COM 1-A and 1-B are developed in Chapter 2 of the Report, recommendation EU COM 1-C is developed in Chapter 3 and recommendation EU COM 1-D is developed in Chapter 4 of the Report.

⁵ Recommendation EU COM2A, 2B and 2C can be found in Chapter 5, Chapter 6 and Chapter 7 of the Report.

that it would not be appropriate to include loans secured by aircraft liens among the underlying asset classes eligible for the risk weight preferential treatment provided for in Article 129 of the CRR.

Recommendation EU COM 2 - B: Residential loans secured by a guarantee

Based on the qualitative and quantitative evidence included within this report the EBA considers it appropriate to maintain residential loans secured by a guarantee within the scope of preferential risk weight treatment. However the EBA deems appropriate that, in addition to the qualifying criteria currently included in Article 129(1)(e) of the CRR, the following additional criteria be considered for inclusion:

- i. The national legal/regulatory covered bond framework should not allow borrowers to place mortgage liens on the loans included in the cover pool ;
- ii. The national legal/regulatory covered bond framework should be such that no legal impediments exist for the administrator of the covered bond programme to place mortgage liens on the loans included in the cover pool, in a scenario where the covered bond issuer has entered default or resolution and where the guarantee, for any reasons, ceases to exist;

Recommendation EU COM 2 - C: Derogation on RMBS/CMBS in cover pools⁶

The EBA considers it appropriate that the derogation to the 10% limit for senior securitisation units currently foreseen in Article 496 of the CRR, be removed after 31 December 2017.

⁶ Recommendation EU COM 2 – C relates to the derogation on RMBS/CMBS in cover pools. The EBA notes that in at least one Member State, intra-group transfers of collateral, i.e. covered bonds issued by an entity in the group and transferred into the cover pool of the covered bond program of another entity within the same group, have so far been based on Article 496 (1) a) and b) CRR. The assessment of the use of Article 496(1) CRR for such purposes is outside the scope of this report, but the EBA nonetheless recommends that the Commission should further consider whether a specific provision could be introduced in Article 129 CRR making it possible to allow specific intra-group transfers of CRR-compliant covered bonds as eligible collateral. From a prudential perspective, no additional risk appears to be introduced by such a provision, provided that the entity is sufficiently integrated into the group.

Specific proposals and supporting analysis

The Report accompanying this opinion develops the analysis which was carried out to substantiate the different recommendations to the European Commission and presents, within the relevant chapters, an illustration of the rationale behind each recommendation.

Addendum to the Opinion

Principles of best practice in relation to covered bonds: EBA response to ESRB Recommendation E on funding of credit institutions⁷

Recommendation E of the ESRB recommendations on funding of credit institutions requested the EBA to deliver to the ESRB an interim report setting out the principles of best practice in relation to covered bonds which the EBA has identified together with national supervisory authorities.

The Report the EBA developed to substantiate this Opinion to the European Commission also develops the analysis necessary to support the identification of best practices addressed to the ESRB.

For this reason the best practices identified by the EBA in relation to eight crucial aspects of safety and soundness of the covered bond are listed below.⁸

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 case of issuer's default, 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*⁹ with the claim of the issuer's unsecured creditors.

⁷ (ESRB 2012/2).

⁸ Identified best practices 1 to 7A are developed in Chapter 2 of the Report. Best practices 7-B and 7-C are developed in Chapter 3 of the Report. Best practices 8-A and 8-B are developed in Chapter 4 of the Report.

⁹ In the case of non-deposit-taking specialised covered bonds issuers, i.e. issuers whose business only or mostly focuses on the issuance of covered bonds, the covered bond investor could be granted a claim on the covered bond issuer's insolvency estate which ranks senior to the claim of the issuer's unsecured creditors.

Segregation of cover assets and bankruptcy remoteness of covered bonds

Best practice 2 - A: Segregation of 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 the registration of the cover assets into a cover register and / or by the transfer of the cover assets to a special entity (SPV or specialised institution). The covered bond legal/regulatory framework should ensure that the establishment of the cover register and/or the transfer of the (cover) assets to a special entity result in legally binding and enforceable arrangements, including in the event of default or resolution of the issuer.

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

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 issuer's default or resolution, 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 the insolvency proceedings related to the issuer's default giving priority to the covered bond investor and any other parties whose claim ranks 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 at all times a plan in place specifying the operational procedures aimed at ensuring an orderly functioning of the covered bond programme upon default or resolution of the issuer.

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

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

The legal/regulatory covered bond framework should provide for clear and sufficiently detailed provisions over the duties and powers of the administrative function so as to ensure that the latter can take all action which may be necessary for the full realisation of the interests of the covered bonds investor, while maintaining a high level of legal clarity and transparency vis-à-vis the investor over the covered bond management in scenarios of potential distress such as the issuer's default or resolution.

Characteristics of the cover pool

Best practice 3 - A: Composition of the cover pools

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 the cover assets. The EBA considers that regulatory limits on the composition of these 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 also acknowledges 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.

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.

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

The legal/regulatory covered bond framework should provide that cover pools are generally limited to comprise of assets located in the EEA, as this ensures that liquidation of collateral in the case of issuer default 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 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 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 Union, as per Article 107(4) of the CRR.

Valuation of mortgage cover assets and LTV criteria

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 of coverage of the liabilities of the covered bond programme (so-called '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.

Best practice 4 - B: LTV measurement and frequency of re-valuation

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) 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. The framework should specify that the re-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 subparagraph of Article 229(1) of the CRR.

Coverage principle and over-collateralisation

Best practice 5: Coverage principles and legal/regulatory over-collateralisation

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 the covered bond issuance, are covered by the cover assets.

The EBA considers that a legal/regulatory minimum over-collateralisation level constitutes a regulatory best practice. The recommendation of a quantitative legal/regulatory minimum over-collateralisation level would require further analysis as it depends on several factors including, but not limited to, the class of cover assets as well as, 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.).

Assets and liabilities risks

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 issuer insolvency.

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 out-flows 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 conditional pass-through structures - expose to different extents the covered bond programme to liquidity risk.

Best practice 6 – C: Stress testing

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

the following factors:

- Shifts of relevant interest rate curves based on historical performance, where data is available;
- Shifts of 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 re-payment 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 test should also take into account other risks, including but not limited to, set-off risks and commingling risks.

Role of the competent authority and monitoring of the cover pool

Best practice 7 - A: Appointment of the Cover Pool Monitor

The legal/regulatory covered bond framework should provide that, at 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 bonds issuer; ii) provide for the eligibility criteria for the appointment 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 the 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.

Best practice 7 - B: Supervision of covered bond issuer

The legal/regulatory covered bond framework should provide that the competent authority approves the establishment, by a given issuer, of a covered bond programme. A covered bond programme shall be considered to have been 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 which rank *pari passu* with the claims attached to the existing bonds collateralised by the same cover pool, in the event of 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 event of issuer insolvency or resolution; ii) where provided by the national framework, the restrictions applicable to the issuer are met; 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 the covered bonds issuance activity and related ancillary activities, may ensure a level of supervision of the issuer which is comparable to the one achieved by the authorisation of the establishment of a new covered bond programmes. In any case all the applicable requirements attached to the granting of the licence should be regularly monitored

and the establishment of new covered bond programmes should as a minimum be subject to ex-ante notification 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 the applicable activities/regulatory requirements of covered bond issuers.

Best practice 7 - C: Duties and powers of the national authority in the event of issuer insolvency

The legal/regulatory covered bond framework should provide a sufficiently detailed description of the duties and powers of the competent authority on the covered bond programme, as well as its administration, in the event of issuer's default.

Disclosure to investors

Best practice 8 – A: Scope of disclosure

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

Best practice 8 - B: Frequency of disclosure

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

This opinion and the supporting report will be published on the EBA's website.

Done at London, 30 June 2014

[signed]

Andrea Enria

Chairperson
For the Board of Supervisors

