EBA ADVICE ON THE REVIEW OF THE EU COVERED BOND FRAMEWORK

RESPONSE TO THE COMMISSION'S CALL FOR ADVICE OF JULY 2023

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ABBREVIATIONS

AE	Asset Encumbrance
APP	Asset Purchase Programme
BRRD	Bank Recovery and Resolution Directive
CBD	Covered Bond Directive
CBPP	Covered Bond Purchase Programme
CfA	Call for Advice
COM	European Commission
COREP	Common Reporting Framework
CPM	Cover Pool Monitor
CPT	Conditional Pass-Through
CQS	Credit Quality Step
CRD	Capital Requirements Directives
CRE	Commercial Real Estate
CRR	Capital Requirements Regulation
EBA	European Banking Authority
ECB	European Central bank
ECBC	European Covered Bond Council
EEA	European Economic Area
EMIR	European Market Infrastructure Regulation
EP	European Parliament
ESG	Environmental, Social and Corporate Governance
ESN	European Secured Note
EU	European Union
FINREP	Financial Reporting Standard
HQLA	High-Quality Liquid Assets
IRBA	Internal Ratings-Based Approach
ITS	Implementing Technical Standards
LCR	Liquidity Cover Ratio
LGD	Loss Given Default
LTV	Loan to Value
MLV	Mortgage Lending Value
NCA	National Competent Authority
NPV	Net Present Value
PSE	Public Sector Entity
RGLA	Regional Government or Local Authority
RRE	Residential Real Estate
SA	Standardised Approach
SB	Soft Bullet
SIU	Savings and Investments Union
SME	Small and Medium Enterprise
SPV	Special Purpose Vehicle
TLTRO	Targeted Longer-Term Refinancing Operations
UCITS	Undertakings for Collective Investment in Transferable Securities

EXECUTIVE SUMMARY

Introduction and purpose

The covered bond market is well established in the EU and constitutes a key source for cost-effective and long-term banks funding for European institutions. Data shows that at the end of 2024 EU-issued covered bonds accounted for approximately 2.5 trillion euro out of the 3.3 trillion euro outstanding worldwide. (1) Additionally, covered bonds have confirmed their position as a resilient source of financing in times of distress, most recently during the global financial crisis in 2008. Advancing the integration of this market falls within the scope of the plans for SIU and has been the target of recent work at the EU level.

Prior to 2019, a minimum, high-level EU-wide harmonisation of the national frameworks was implicitly granted in accordance with Article 52(4) of the UCITS Directive. (2) Additionally, Article 129 of the CRR laid down the criteria to be met in order to be granted the preferential regulatory capital treatment for banks' holdings in the form of covered bonds. However, the absence of a truly harmonised covered bond framework meant that this preferential treatment was assigned to instruments of a different nature and level of risk, which in turn created obstacles to the development of an integrated single market for covered bonds in the EU. (3)

On 27 November 2019, the EU adopted a covered bond legislative package composed of the Covered Bond Directive (CBD) (4) and the Regulation on exposures in the form of covered bonds (5) amending the Capital Requirements Regulation (CRR). (6) That package set out a comprehensive minimum harmonisation framework that all covered bonds issued in the EU must meet. Member States were effectively given until the 8 July 2022 to adopt the necessary transposition measures to comply with the CBD.

As a follow-up after the full transposition of the Directive by Member States, Article 31 of the CBD mandated the COM to submit several reports to the co-legislators on the implementation of the covered bond framework and various other related matters, that may be accompanied with legislative proposals, if appropriate. In turn, the EBA received a Call for Advice (CfA) from the COM in July 2023, (7) where input and technical advice was requested to conduct the review referred to in Article 31 of the CBD.

(1) See the ECBC Factbook 2025.

(2) Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) (OJ L 302, 17.11.2009, p. 32, ELI: http://data.europa.eu/eli/dir/2009/65/oj*)*.

(3) In 2016, the EBA had already prepared a thorough analysis in the form of a Report (EBA-Op-2016-23) following a Call for Advice from the ESRB on the review of the best practices in the EU covered bond market, before the implementation of the CBD.

(4) Directive (EU) 2019/2162 of the European Parliament and of the Council of 27 November 2019 on the issue of covered bonds and covered bond public supervision and amending Directives 2009/65/EC and 2014/59/EU (OJ L 328, 18.12.2019, p. 29, ELI: http://data.europa.eu/eli/dir/2019/2162/oj).

(5) Regulation (EU) 2019/2160 of the European Parliament and of the Council of 27 November 2019 amending Regulation (EU) No 575/2013 as regards exposures in the form of covered bonds (Text with EEA relevance)(*OJ L 328, 18.12.2019, p. 1, ELI:* http://data.europa.eu/eli/reg/2019/2160/oj).

(6) Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 (*OJ L 176, 27.6.2013, p. 1, ELI:* http://data.europa.eu/eli/reg/2013/575/oj).

(7) See the Call for advice to the European Banking Authority on the performance and review of the EU covered bond framework.

In preparing this report, the EBA developed an analysis of the EU covered bond framework along four different dimensions: a) the **harmonisation** of the EU covered bond framework, b) the enhancement of the **safeguards and** the **disclosure requirements** of the national frameworks, c) the **alignment** between different EU regulatory frameworks **and** the consequent **simplification**, and d) **new regulatory instruments** to develop and expand the EU covered bond market. The EBA has also identified a series of best practice recommendations to cover areas not yet reflected in common EU legislation or not sufficiently clarified within the existing framework.

Harmonising further the EU covered bond framework

The harmonisation of the regulatory framework at the EU level is one of the most important areas of the review. While the CBD has undoubtedly reduced regulatory and market fragmentation, it has been inspired by a principle-based approach. This approach has left considerable flexibility to Member States in their transposition, along with a large number of national discretions. The EBA has identified a few aspects of the CBD that have potential for further harmonisation, which relate to the structural features of covered bonds.

There are various reasons why intervention towards a higher level of harmonisation is beneficial to a well-functioning market. It removes regulatory arbitrage across jurisdictions, makes EU covered bonds more easily comparable to the investor, improves the overall quality of this financial instrument by setting minimum EU-wide standards, ([8]) and ultimately reduces market fragmentation and strengthens the SIU.

ELIGIBILITY OF COVER ASSETS

The CBD currently allows for three different types of assets in the cover pool: those under Article 129 of the CRR, and those that fall outside its scope but are either of high quality or in the form of exposures to public undertakings, both of them subject to additional requirements. The definition of the latter two is largely at the discretion of Member States and includes a high variety of often largely unused asset types.

The EBA has identified in this discretion sources of concern in terms of a) regulatory harmonisation, b) comparability of cover assets across jurisdictions, and c) lack of supervisory experience with these assets. For these reasons, the EBA recommends **restricting cover asset eligibility to those assets that qualify under Article 129 of the CRR (Recommendation 1)**.

DEFINITION OF THE COMPOSITION OF THE COVER POOL

Cover pools are usually composed by a primary type of asset, which is often the dominant one in the pool, and one or more substitution assets. The CBD leaves great flexibility in the defining of primary and substitution assets.

To help the investor to clearly identify to which type of collateral he is exposed (and hence the character of the covered bond), as well as to easily compare different instruments across jurisdictions, the EBA recommends – within the principle-based approach of the provision – **the definitions of primary and substitution assets to be sufficiently specified in the legislation (Recommendation 2)**.

COVER POOL MONITOR

The CBD gives the option to Member States to require the issuer to appoint a cover pool monitor (CPM) (i.e. a body that acts as an additional safeguard, especially given the high reliance on issuer-internal proceedings for segregation of the cover assets). In accordance with the CBD, Member States shall ensure the independence and separateness of the monitoring functions from the issuer and its annual auditor.

At the same time, the CBD allows for the **appointment of an internal cover pool monitor**

([8]) See Article 27 of the CBD.

(i.e. a CPM composed by employees or branches of the issuer institution tasked with this function), which the EBA has judged to be incompatible with the principles of independence and separateness in spite of the safeguards provided. Given also the fact that the appointment of internal CPMs is rarely used in the EU, the EBA recommends **an outright elimination of this discretion** (with the possibility of a transition period with enhanced safeguards) **(Recommendation 7)**.

EXTENDABLE MATURITIES

The CBD allows for covered bonds with extendable maturity structures, a feature designed to offer the investor an additional guarantee of an orderly wind down of the cover pool after issuer default, avoiding fire sales. Clearly, the extension of the maturity should never be indefinite, nor should it undermine the dual recourse structure. Most Member States allow for this discretion, and the market has now set extendable maturity structures as the standard.

In its analysis, the EBA followed the overarching principle of ensuring that the maturity extension is triggered for the benefit of the investor rather than to solve issuer problems unrelated with the covered bond. The EBA developed its recommendations on the common ground of a more active involvement of both the NCA and the investor in the control of the issuer's involvement in the extension.

Since the circumstances that may initiate the extension process are often unspecified and largely left at the discretion of the issuer, the EBA recommends **Member States to clearly define via their respective NCAs the extension triggers in terms of a finite objective list of events** that must occur **(Recommendation 20)**.

In addition, the EBA stresses the need to control the actual need for a maturity extension and to assess the responsibilities of the issuer. Therefore, it recommends **introducing a mandatory assessment of the involvement of the issuer in the run-up to the realisation of the trigger to be performed by the NCAs** to avoid that the issuer may be tempted to extend covered bonds to solve problems related to the redemption of non-extendable payment obligations **(Recommendation 21)**.

Lastly, the EBA recommends **introducing requirements aimed to an active involvement of the investor in the follow-up to the extension**, with the goal of performing an ad-hoc unlikeliness to pay assessment to rule out the possibility of an embedded forbearance measure **(Recommendation 22)**.

LIQUIDITY REQUIREMENTS

The CBD lays down rules for the constitution and the utilisation of a liquidity buffer, a pool of highly liquid assets to cover net outflows in the next 180 days following the issuer's default. Member States have the discretion to use, in the calculation for the 180 days of coverage, the final maturity date for principal payment obligations that could be, but not yet are, extended subject to certain triggers being met (i.e. after extension). Given the standard extension scheme of 12 months, this would hinder the liquidity buffer requirement.

The EBA focused its analysis on the rationale of this discretion, on the ground that the use of this option in cases of hypothetical extension prior to issuer default may lead to a period in which neither liquidity in the liquidity buffer is available, nor an additional extension could be used for transitioning into the orderly wind down of the covered bond. In addition, an issuer facing obvious difficulties would have to be able to replenish the liquidity buffer in typically a half-year time only. The risk of such a recovery failing is thus allocated to large extent to the covered bond investor.

As a solution, the EBA recommends **introducing additional safeguards to continue allowing the use of the discretion to ensure consistency between the objective maturity triggers and the ability of the issuer to extend** in case of insolvency [9] **and to ensure** credible mechanisms **to reconstitute the depleted liquidity buffer (Recommendation 24)**.

[9] With exceptions depending on the covered bond model adopted.

Strengthening safeguards and disclosure in all national frameworks

Covered bonds have proved to be a very safe investment product. The labels of 'European Covered Bond' ([10]) and 'European Covered Bond (Premium)', ([11]) whose conditions for utilisation are explicitly granted by the CBD, benefit from a strong reputation among investors. This translates into a premium paid by investor, which confirms the relatively lower issuing cost for institutions.

Thanks to the CBD, the quality and the safety of the product are guaranteed by numerous provisions, which contribute to the functioning of the dual recourse mechanism. This grants investors a preferential claim over unsecured investors in case of issuer default. Among these provisions, the most important are the safeguards ensuring the quality of certain types of assets in the cover pool, such as derivative contracts, the provisions guarantying an effective coverage of the instrument, and all the investor information disclosure requirements.

Despite the perceived high safety of covered bonds, the fact that there is a certain degree of heterogeneity in the strictness of the safeguards applied, and in the information disclosure, gives a rationale for a thorough assessment of the effectiveness of such provisions in terms of consumer protection.

SAFEGUARDS IN USING DERIVATIVE CONTRACTS IN THE COVER POOL

Derivatives hedge against a number of risks (e.g. interest rate, exchange rate) that can undermine the value of the cover assets, but they may expose the investor to the termination of the contract in case of issuer insolvency. This is a substantial issue in the case an issuer and its counterparty are the same entity (like in SPV covered bond models), or where the parties are within the same scope of prudential consolidation.

To avoid contract termination and to continue guarantying the investor the protection offered by the derivative, the EBA recommends **strengthening the safeguards by requiring counterparties to post high quality collateral, and to ensure full segregation of the contract (Recommendations 4 and 5)**. If the counterparty is internal or part of the same scope of prudential consolidation as the issuer, **an alternative counterparty should be appointed** to step into the derivative contract **upon default or downgrade of the original counterparty (Recommendation 6)**.

COVERAGE REQUIREMENTS

To ensure that all covered bond-related liabilities are factored-in at all times, the CBD lays down the minimum requirements to cover effectively all the payment obligations (the 'statutory coverage regime'), which includes the principles to be adopted to define the coverage of all obligations, the methods for its calculations, the use of over-collateralisation and the contribution of defaulted collateralised assets.

The EBA has identified a lack of precise definitions of some of the aspects of the statutory coverage regimes at the national level and therefore recommends **Member States to lay down clearer rules (Recommendations 9, 10, 11, and 12)**. For principal obligations, these include adjusting the nominal amount by variations coming from net valuation adjustments, risk provisions, and fluctuations in market prices. For non-principal obligations, these include taking into account all future interest-related obligations and any expected winding down costs in case of default. For the methodology of the coverage assessment, these include reflecting all potential changes in the parameters, and a typically no less than business daily frequency of calculation.

Over-collateralisation provides an essential buffer against fluctuations in value and/or sudden de-registration of cover assets from the pool. In this regard, the EBA recommends **strengthening the**

([10]) 'European Covered Bond' refers to covered bonds that comply with the requirements laid down in the CBD.

([11]) 'European Covered Bond (Premium)' refers to covered bonds that – in addition to the CBD requirements – comply also with those laid down in Article 129 of the CRR and are therefore the preferential risk treatment as per credit risk regulation.

conditions for deviating from the statutory over-collateralisation (Recommendation 13), whose assessment shall be in no case left to the issuer.

The EBA identified risks associated with collateralised cover assets for which a default (in the sense of the CRR) has occurred and therefore recommends to at least **partially disregard or** to **carefully reassess the contribution of such assets for coverage purposes (Recommendation 14)**.

GREEN COVERED BONDS AND ESG RISKS OF COVER POOLS

ESG disclosure is currently outside the scope of the EU covered bond framework. Institutions are required to report taxonomy alignment and climate risk metrics related to their overall balance sheet, but no information is given at the cover pool level.

The EBA is of the opinion that disclosing ESG-related metrics at the cover pool level is of particular importance for investors, as it provides information on the risks to which they would be exposed in case of issuer default and subsequent separation of estates.

In adopting a cautious approach aimed at balancing the costs in terms of reporting burden, and the benefits in terms of investor protection, the EBA recommends **limiting the scope of the disclosure in the CBD to climate risk (transition and physical) of immovable property to an annual frequency, and only for the cover assets for which climate risk metrics are available (Recommendation 25)**.

TRANSPARENCY

A key feature of the high quality covered bonds is the transparency and the completeness of the information that is required to be disclosed to the investor. The CBD requests issuers to disclose at a relatively high frequency (at least quarterly) information on several aspects such as the composition of the cover pool, the associated risks, the maturity structure of the underlying assets, the percentage of assets under default etc.

At the same time, the framework is silent with respect to how such information should be disclosed, leaving high flexibility to the issuer. During the past years, most of the industry has converged to the adoption of the Harmonised Transparency Template (HTT) provided by the ECBC as a market standard. Considering the role of this market initiative, the EBA is of the opinion that the principle-based approach of the CBD is fit for purpose, and it recommends **Member States to mention in the national regulation the preferred (voluntary) modality of (compulsory) disclosure**, as it is already the case in some jurisdictions **(Recommendation 8)**.

Simplifying the framework by aligning further the CBD and CRR

Although harmonisation across national jurisdictions plays a pivotal role in contributing to the smooth functioning of the EU covered bond market and in removing the possibility of regulatory arbitrage, the EBA deemed it useful to also perform an overall assessment of the level of alignment across the different provisions of the EU frameworks to seek potential improvement.

In this regard, the entry into force of the Basel III Accord, and the subsequent transposition in the new CRR III, brought significant changes in the credit risk provisions that are likely to result in inconsistencies with the covered bond framework. Among the various differences in the treatment of covered bonds between the two frameworks, the EBA has chosen to focus specifically on the treatment of real estate under construction for the purpose of cover pool eligibility, on the valuation method applied to immovable property for the purpose of coverage requirements and preferential risk treatment, and on other provisions related to specific assets.

The EBA is of the opinion that the need for alignment responds to the recent call for the simplification of different areas of the EU SIU regulatory framework, ([12]) but that it can also be an opportunity to resolve cross-country differences in various aspects related to the treatment of covered bonds by applying a uniform framework dictated by the CRR III. In addition, further harmonisation can help reduce the costs of compliance for the institutions, as well as the risks associated with a non-prudent valuation, as generally speaking the CRR III has more stringent requirements for preferential risk treatment than the CBD has for the purpose of cover asset eligibility.

TREATMENT OF REAL ESTATE UNDER CONSTRUCTION

There are important differences in the treatment of real estate exposures (i.e. 'mortgages') as credit risk exposures and within the EU covered bond framework in terms of cover asset eligibility. To qualify as real estate for the purpose of the credit risk framework, the immovable property that secures an exposure must be finished or used as a primary residence, with only a few exceptions. In contrast, when it comes to eligibility for coverage purposes, Member States apply heterogeneous provisions, with some already aligning to the credit risk framework, while others allow commercial and/or residential real estate under construction.

In the spirit of further simplification, as well as of a higher degree of protection to the covered bond investor that is guaranteed by a stricter selection of eligible assets, the EBA recommends **a full alignment between the covered bond framework and the credit risk framework for real estate collateral (Recommendation 26)**.

VALUATION METHODS FOR IMMOVABLE PROPERTY

With the entry into force of the CRR III, institutions have to apply prudent valuation for the purpose of the general credit risk framework. At the same time, the CBD still allows the use of market value for the valuation of collateral. ([13]) This difference in treatment is amplified in the heterogeneity of national valuation methods, with some Member States allowing only prudent valuation or mortgage-lending valuation, some others market value, and some other both of them. ([14])

The EBA analysed in detail the merit of an alignment of the two frameworks. On one side, such an alignment to prudent valuation would set a further step towards regulatory simplification, it would shield the investor from excessive market prices fluctuations and, where two valuation methods are used, it would simplify its assessment of the risks to which they are exposed. At the same time, the EBA acknowledges that a restriction on the use of market value may impact unevenly on the different markets, depending on the traditional market practices and the covered bond model adopted. The EBA, **while restating the merit of a full alignment in the spirit of regulatory simplification,** recommends to **the COM to further assess the costs and benefits of such a change in regulation (Recommendation 27)**.

TREATMENT OF COVERED BOND IN THE PRESENCE OF A DEFAULTED ISSUER

As part of its review of the two frameworks, the EBA has identified an inconsistency in the treatment of covered bonds in the presence of a defaulted issuer. In accordance with the CRR III, the rules classifying the exposures of the defaulted issuer shall be applicable to all items where the issuer has defaulted, but only on their unsecured part. At the same time, covered bonds are not explicitly regulated in the provisions regarding issuer default. This ambiguity may thus lead to interpret such provisions as not applying to covered bonds of defaulted issuers for as long as they are complying with statutory coverage requirements.

There are reasons for covered bonds to be treated akin unsecured exposures (i.e. because of the passage from first to second recourse, and the loss of dynamic properties of the pool), but at the same time this would simply ignore the reality of a cover pool benefitting covered bond investors on

([12]) See the recent COM Omnibus package on simplification.

([13]) Market value is allowed also by Article 129 of the CRR.

([14]) A few other countries apply instead the Mortgage Lending Value (MLV), which is even more conservative than prudent valuation.

a priority basis, even if deterioration of such cover pool could no longer be augmented by a solvent issuer. For this reason, the EBA is of the opinion that this inconsistency shall be resolved and is **open to receive from the COM a mandate for EBA to review the issue and suggest possible amendments to level 1 text**. The EBA also concluded that the CRR III credit risk provisions shall still fully apply to covered bonds for the time being.

Developing and expanding the EU covered bond framework

Another important aspect under analysis of the EBA Report is the possibility to develop the regulatory framework aimed at an expansion of the market for EU covered bonds, both within and outside the Union.

As to the former, the CfA tasked the EBA to formulate an opinion about the introduction of a dual recourse-like instrument targeted to fund SME loans, also known as European Secured Notes (ESNs). As to the latter, the CfA tasked the EBA to investigate the opportunity to introduce of an equivalence regime for third country covered bonds, and to lay down the design of such a regime in terms of principles and structural features of the legal framework.

THIRD COUNTRY EQUIVALENCE REGIME

The development of new instruments and regulatory frameworks targeted to third countries can act as tool to expand the investor base for EU issuers, contributing to increase the demand for EU products and ultimately to secure an additional and relatively cheap source of funding for EU institutions. In turn, increases in demand and issuance are likely to positively affect the supply of affordable mortgages and loans to households and firms, in a virtuous cycle for the growth of the EU economy. In addition, the establishment of a well-designed third country regime can act as a stimulus for other countries that do not yet have a well-established covered bond market, which would enable the EU to set a worldwide standard for the covered bond regulation.

The COM has acknowledged the potential of such an equivalence regime, and requested the EBA to consider the relevance, prerequisites, scope, implementation steps, and principles to be followed for establishing such a regime.

On **relevance**, the EBA evaluation has concluded **in favour of the establishment of an equivalence regime (Recommendation 15)**. The same conclusion is shared by the industry on the ground that the benefit from increased demand for EU covered bonds outweighs the risk of increased competition from third countries and reputational concerns about the quality of the product.

On **essential requirements** with which the third country shall comply to initiate the equivalence assessment process, the EBA identified as criteria: a) the **definition and regulatory treatment of a credit institution and the concept of a dual-recourse covered bond-like instrument**, b) the **maturity of the third country market** in accordance with specific economic criteria, and c) the **availability of the third country NCA to collaborate under the principle of reciprocity** of treatment as an overarching principle guiding the institutional relationship **(Recommendation 16)**.

On the **scope of the equivalence regime,** the EBA recommends **basing the assessment on the main CBD principles (Recommendation 17)**. ([15]) In addition, the EBA also recommends **further alignment in terms of preferential risk treatment as per the CRR**, **subject to stricter conditions** like the provision of a list of potentially CRR-eligible covered bonds and a certified legal review of the contractual terms **(Recommendation 18)**. Subject to these conditions, third country covered bonds may be treated by EU institutional investors as 'European Covered Bond (Premium)' bonds.

([15]) These principles pertain to the most important requirements a covered bond must satisfy in terms of structural features, public supervision, and publication requirements.

On the **actual process of the equivalence assessment (Recommendation 19)**, the EBA suggests requiring that the application to the COM by the third country should include **a self-assessment of the maturity of the domestic market, of the degree of similarity of the regulatory and supervisory framework**, and also **a declaration of intent to cooperate under** the principle of **reciprocity**.

EUROPEAN SECURED NOTES (ESNS)

The introduction of a dual recourse-like instrument targeted to SMEs has been extensively debated and has also been under study of the EBA in 2018. ([16]) Allowing for SMES loans to be eligible as cover assets would have the merit of increasing the possibility for issuers to secure a relatively cheaper source of funding to foster SMEs financing with an instrument that may appear more suitable than more complex instruments such as securitisation. At the same time, the EBA acknowledges there is a normative void and concerns about the potential quality and the resilience of such an instrument (and the subsequent reputational spill over on an already well-functioning covered bond market). The EBA therefore calls for a **cautious approach and** advocates **a reopening of the debate in the medium term subject to a renewed political interest and build-up of actual market experience ('track record') for such type of instrument**.

([16]) See the EBA Report on the European Secured Notes (ESNs).

1. INTRODUCTION

1.1 General overview of the Call for Advice

The covered bond market is well established in the EU and constitutes a key source for cost-effective long-term funding of banks. Advancing the integration of such a market falls within the scope of plans for the SIU and has been the target of recent works at the EU level.

On 27 November 2019, the EU adopted a covered bond legislative package composed of the Covered Bond Directive (CBD) ([17]) and the Regulation on exposures in the form of covered bonds ([18]) amending the Capital Requirements Regulation (CRR). ([19]) This package sets out a comprehensive minimum harmonisation framework that all covered bonds issued in the EU must meet. Member States were effectively given until 8 July 2022 to adopt the necessary transposition measures to comply with the CBD. ([20])

As a follow-up after the full transposition of the Directive by Member States, Article 31 of the CBD mandates the COM to submit several reports to the co-legislators on the implementation of the covered bond framework and various other related matters accompanied with any related legislative proposals that are deemed appropriate.

The EBA received a Call for Advice (CfA) from the COM in July 2023, ([21]) where input and technical advice was requested to conduct the review referred to in Article 31 of the CBD. The CfA mandates the EBA to provide by June 2025 an assessment on five topics, the first four of which follow directly from Article 31, and relate to an assessment of:

A. the performance and functioning of the covered bond framework (Article 31(2) of the CBD);

B. additional items in Article 31 of the CBD:

   B.1 the merits and design of a third country equivalence covered bond regime (Article 31(1) of the CBD);

   B.2 the need for updating the EBA assessment on European Secured Notes (Article 31(5) of the CBD);

   B.3 the risks and benefits of covered bond with extendable maturities. (Article 31(2)(f) of the CBD);

C. green covered bonds and ESG in cover pools.

In order to inform the report for this CfA, questionnaires were sent out to NCAs and industry to gather relevant information. This report is also being supplemented with qualitative and quantitative data. The qualitative data was gathered

([17]) Directive (EU) 2019/2162 of the European Parliament and of the Council of 27 November 2019 on the issue of covered bonds and covered bond public supervision and amending Directives 2009/65/EC and 2014/59/EU (OJ L 328, 18.12.2019, p. 29, ELI: http://data.europa.eu/eli/dir/2019/2162/oj).

([18]) Regulation (EU) 2019/2160 of the European Parliament and of the Council of 27 November 2019 amending Regulation (EU) No 575/2013 as regards exposures in the form of covered bonds (OJ L 328, 18.12.2019, p. 1, ELI: http://data.europa.eu/eli/reg/2019/2160/oj).

([19]) Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 (OJ L 176, 27.6.2013, p. 1, ELI: http://data.europa.eu/eli/reg/2013/575/oj).

([20]) In 2016, the EBA had already prepared a thorough analysis in the form of a Report (EBA-Op-2016-23) following a Call for Advice from the ESRB on the review of the best practices in the EU covered bond market, before the implementation of the CBD.

([21]) See the Call for advice to the European Banking Authority on the performance and review of the EU covered bond framework.

via notification templates. (22) The quantitative data was developed on the basis of EBA supervisory reporting and market data, as of December 2024, and addresses essential points included in the report that require numerical evidence.

The scope of the analysis is to evaluate the performance and the functioning of EU covered bond markets. It considers:

- the average levels of issuance, outstanding volumes, and main market trends;
- the assessment of the volumes of covered bonds eligible for the preferential risk weight treatment;
- the level of over-collateralisation;
- the spreads between the yields of covered bond holders vis-à-vis other types of instruments;
- the liquidity of covered bonds;
- covered bonds and financial stability;
- the investor base of covered bonds.

In addition, this report evaluates asset encumbrance levels and trends of EU credit institutions issuing covered bonds and the contribution of covered bonds to total asset encumbrance.

1.2 Overview of the questionnaire addressed to the NCAs

The questionnaire addressed to NCAs collects information on twenty-four EU jurisdictions. Out of the three missing, Malta is currently developing a national legal framework for covered bonds which will ultimately complete the implementation of the CBD, while Croatia and Latvia do not have an active covered bonds market.

The questionnaire was composed of thirteen different sections, each of which covered one or more aspects related to covered bonds – inside or outside the perimeter of the CBD – which are part of the CfA. The structure of the questionnaire reported in Figure 1, includes a reference to the corresponding CBD Article where relevant.

Figure 1: Overview of the structure of the questionnaire addressed to the NCAs

Section	Subsection	No of questions
1. Legislation and covered bond model overview		4
2. Definitions	2.1 The understanding and definition of covered bond programme and its implementation	1
3. Overview of national discretion	3.1 CBD related	18
	3.2 CRR related	2

(22) These notifications are referred to in the CBD (and in Article 129 of the CRR) and shall be mandatorily transmitted by NCAs to the EBA.

Section	Subsection	No of questions
4. Cover assets	4.1 Eligible cover assets (Article 6 of the CBD)	17
	4.2 Valuation requirements	8
	4.3 Geographical location (Article 7 of the CBD)	2
	4.4 Intragroup pooled covered bond structures (Article 8 of the CBD) and joint funding (Article 9 of the CBD)	2
	4.5 Derivative contracts (Article 11 of the CBD)	8
	4.6 Composition of the cover pool (Article 10 of the CBD)	5
5. Coverage requirements (Article 15 of the CBD)		8
6. Liquidity requirements (Article 16 of the CBD)		5
7. Extendable maturity (Article 17 of the CBD)		15
8. Asset encumbrance		2
9. Overview of aspects where in the EBA 2016 report it was proposed voluntary convergence only		2
10. Cover pool monitor (Article 13 of the CBD)		10
11. Cover pool supervision (Article 18 of the CBD)		3
12. Transparency (Article 14 of the CBD)		4
13. Third country covered bonds		2

1.3 Overview of the questionnaire addressed to the industry

In addition to the questionnaire addressed to NCAs, the EBA also issued a questionnaire to industry on the topics covered by the CfA. The questionnaire was informed by a targeted roundtable with industry held in Paris in April 2024, and it consists of four separate sections for each class of respondents: investors, issuers, analysts, and rating agencies. An overview of the sample of respondents is reported in Figure 2.

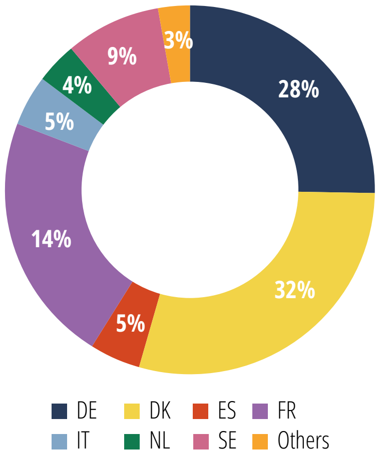
Figure 2: Overview of the sample of respondents to the questionnaire addressed to the industry

Role	No of respondents	Type
Investor	7	4 commercial banks, 2 state-owned banks, 1 non-EEA banking association
Issuing bank	28	21 commercial banks (1 non-EEA), 2 state-owned banks, 5 banking associations (1 non-EEA)
Analyst	4	4 commercial banks
Rating agency	2	2 (Moody's, Scope Ratings)

In addition to the respondents to this questionnaire, some market participants provided additional market insights via a different format (e.g. reports or statements), which the EBA considered in the analysis. Among them, there is one rating agency (Fitch Ratings), as well as issuers' associations, both in EEA and outside the EEA. ([23])

The total outstanding amount of covered bonds issued by entities within the sample of the questionnaire amounts to 1.45 trillion euro which is approximately 80% of the European covered bonds market. ([24]) ([25]) In terms of countries covered, the outstanding volumes are split as reported in Figure 3. ([26])

Figure 3: Coverage of issuers in terms of national market size in percentage of the total outstanding amount of all respondents



Source: EBA calculations, based on COREP data.

The questionnaire was composed of nine different sections, each of which cover one or more subjects treated in the CBD. The questions change in accordance with the role of the respondent, as reported in Figure 4.

Figure 4: Overview of the topics covered by the questionnaire addressed to the industry

Macro subject	No of questions
A. Market dynamics (demand/activity)	Investor: 8; Issuing bank: 9; Analyst: 10; Rating agency: 7
B. Cover pool composition	Investor: 1; Issuing bank: 5; Analyst: 3; Rating agency: 3
C. Liquidity of covered bond market	Investor: 4; Issuing bank: 4; Analyst: 4; Rating agency: 4
D. Third country equivalence	Investor: 3; Issuing bank: 2; Analyst: 5; Rating agency: 4
E. Extendable maturities	Investor: 6; Issuing bank: 4; Analyst: 2; Rating agency: 4
F. Green covered bonds	Investor: 4; Issuing bank: 6; Analyst: 4; Rating agency: 1
G. ESN	Investor: 2; Issuing bank: 2; Analyst: 3; Rating agency: 3
H. Transparency (supervision/due diligence)	Investor: 5; Issuing bank: 2; Analyst: 2; Rating agency: 2
I. Methodology/Data used	Rating agency: 2

The responses collected gave precious insight from a market perspective and complemented to the analysis performed by the EBA in the response to the CfA.

1.4 Legislation and Covered Bond Models

All NCAs have a legislative framework dated or updated after 2019, when the CBD entered into force. As to the implementing supervisory guidelines issued by NCAs, they are mostly related to cover pool monitors and covered bonds issuances. The EBA acknowledges that there is a certain degree of heterogeneity as to the covered

([23]) In particular, the European Covered Bond Council (ECBC), the association that brings together covered bond issuers both in the EU and outside, has provided a very comprehensive overview of the market.

([24]) After excluding banks and banking associations outside the EEA, subtracting institutions that responded both as issuer and investor/analyst, and eliminating those banks and banking associations for which we do not have statistics.

([25]) Source: EBA calculations based on COREP data.

([26]) The relative amounts are obviously not fully representative of the market because of the sample bias in answering the questionnaire. Nevertheless, the discrepancy is not too big in that the major issuers are well captured.

bond model adopted, in addition to the number of CBD discretions, which jurisdictions decided to exercise in transposing the CBD.

As just noted, Member States use different cover bond models. An overview of these models is presented now, and below in Figure 5. ([27])

- **Completely specialised funding institute**: This model entails a parent bank originating and servicing the eligible assets, as well as managing the covered bond. Additionally, there is a covered bond issuer – which has the legal status of a credit institution but generally little to no staff – that serves the sole purpose of a holder of eligible assets, therefore granting their segregation from the balance sheet of the parent bank. The issuance is always governed in accordance with a special legal framework.
- **Specialised credit institution by law**: This model entails an issuer which has the legal status of a credit institution, but whose business model is restricted by national law to originating mortgages and public-sector loans only. The issuer takes care of the whole process of the issuance, sale, and payment related to the instrument. It should be noted that – unlike completely specialised institutions – such entities may have a (usually limited) amount of non-eligible assets in their balance sheet, which generally will not be a part of the segregated pool of assets. The issuance is always governed in accordance with a special legal framework.
- **Universal credit institution**: This model entails a standard universal bank that among their business also operates in the covered bond market. The institution takes care of the whole process of issuance, sale, and payment related to the instrument. The variety of asset types used for coverage purposes is usually higher than that of specialised credit institutions. Being universal, the vast majority of the balance sheet is constituted by non-segregated assets, as the institution is usually active in granting loans in the non-eligible sector. The issuance is always governed in accordance with a special legal framework.
- **Credit institution using an SPV**: This model entails a (usually universal) credit institution that takes care of the whole process of issuance, sale, and payment related to the instrument, but operates in the covered bond business by setting up a (legally separated) special purpose vehicle (SPV), to which eligible cover assets are transferred. The SPV then acts as a guarantor of segregation of the cover assets. There are two main differences with respect to the previous models. First, the SPV does not have the legal status of a credit institution and second, the issuance is not regulated in accordance with a special legal framework but is rather based on general law (which also covers provisions related to the functioning of an SPV).
- **Pooling model**: this model entails a central refinancing entity for its multiple shareholder banks. This entity issues covered bonds to fund loans to these banks, with each loan secured by high-quality residential mortgages (which are granted to borrowers by the banks themselves). These loans are usually highly over-collateralised, and in the event of a bank default, the entity is entitled to the full ownership of the cover assets. The entity generally benefits from a solidarity mechanism among its shareholders. ([28])

([27]) Note that some countries allow more than one models.

([28]) In the EU, this model is allowed in two countries, France and Hungary. In France, the 'Caisse de Refinancement de l'Habitat (CRH)', established in 1985 under a dedicated legal framework, operates in accordance with this business model by issuing covered bonds. Its shareholders are the five major banking groups of the country.

Figure 5: Overview of covered bond models adopted in the EU Member States

Covered bond model	Member States
Model 1: Covered bond issuer as a completely specialised funding institute	FR, HU (29)
Model 2: Covered bond issuer as a specialised credit institution by law	DK, FI, HU, (29) IE, LU, PL
Model 3: Covered bond issuer as a universal credit institution	AT, BE, BG, CY, CZ, DE, DK, (30) EE, EL, ES, FI, LU, PT, RO, SE, SI, SK
Model 4: Covered bond issuer using SPV to achieve insolvency segregation of cover assets	IT, LT, NL
Model 5: Pooling Models	FR, (31) HU (29)

1.5 Overview of national discretion

National discretions are authorised throughout the CBD and in Article 129 of the CRR. In general, what emerges from our analysis is that the majority of Member States exercise national discretions in more than one subjects covered by the CBD and the CRR. However, in many cases the discretion has never been used in practice. An overview of the utilisation of the discretions allowed by the CBD and the CRR is reported in Figure 6 and Figure 7 respectively.

1.5.1 DISCRETION RELATED TO THE CBD

Figure 6: Overview of discretions applied by EU Member States in the CBD

Article	Yes	No
Article 4(3) – Dual recourse	DK, IE, PL	AT, BE, BG, CY, CZ, DE, EE, EL, ES, FI, FR, HU, IT, LT, LU, NL, PT, RO, SE, SI, SK
Article 6(3) – Eligible cover assets	CY, EE, EL, LU	AT, BE, BG, CZ, DE, DK, ES, FI, FR, HU, IE, IT, LT, NL, PL, PT, RO, SE, SI, SK
Article 7(1) – Extra-EU/EEA collateral	AT, (32) BG, (33) CY, (33) DE, (32) DK, (33) EL, ES, FR, (32) IE, (32) IT, (32) LT, (33) LU (32)	BE, CZ, EE, FI, HU, NL, PL, PT, RO, SE, SI, SK
Article 8 – Intragroup pooled CB	AT, (33) DK, BG, (33) CY, (33) EL, (33) ES, LU, PT, (33) RO, (33) SI (33)	BE, CZ, DE, EE, FI, FR, HU, IE, IT, LT, NL, PL, SE, SK
Article 8 (last paragraph)	AT, BG, (33) CY, DK, EL, (33) ES, LU, PT, (33) RO, SI (33)	BE, CZ, DE, EE, FI, FR, HU, IE, IT, LT, NL, PL, SE, SK
Article 9(2) – Joint funding	AT, BG, (33) CY, (33) CZ, EL, (33) ES,FI, FR, IE, (33) LU, NL, SE, SI, (33) SK (33)	BE, DE, DK, EE, HU, IT, LT, PL, PT, RO
Article 9(3) – Joint funding	AT, (34) BE, (33) CY, (33) DE, EL, (32) (33) FI, (33) ES, IE, IT, (33) LU, SE, (33) SK (33)	BG, CZ, DK, EE, FR, HU, LT, NL, PL, PT, RO, SI
Article 13(4) – Cover pool monitor	AT, BE, CY, DE, EE, EL, ES, FR, HU, IE, IT, LT, LU, NL, PL, PT, RO, SI, SK	BG, CZ, DK, FI, SE

(29) It is indifferent that the asset was originated by the mortgage bank itself, or purchased, or refinanced. Mortgage banks are allowed to operate with any other banks. This relation needs a strong operative cooperation, but this a contractual relation, not a formally defined scope of consolidation.

(30) Limited to only one universal credit institution issuing covered bond from a separate register.

(31) Limited to only one issuer.

(32) Limited to certain countries.

(33) So far there has been no utilisation of this discretion.

(34) Utilisation limited to certain claims.

Article	Yes	No
Article 15(3) – Coverage requirements	AT, BE, BG, (33) CY, (33) CZ, DE, DK, EE, EL, ES, FR, HU, IE, IT, LT, LU, NL, PT, SE, SI, (33) SK,	CZ, FI, PL, RO
Article 15(6) – Coverage requirements	CY, (33) EE, EL, FI, FR, HU, IE, IT, LT, PL, PT, SE, SI, (33) SK	AT, BE, BG, CZ, DE, DK, ES, LU, NL, RO
Article 15(7) – Coverage requirements	CY, (33) DK, EL, ES, PT	AT, BE, BG, CZ, DE, EE, FI, FR, HU, IE, IT, LT, LU, NL, PL, RO, SE, SI, SK
Article 15(8) – Coverage requirements	CY, EL, ES, IE, LT, (33) SE, SK	AT, BE, BG, CZ, DE, DK, EE, FI, FR, HU, IT, LU, NL, PL, PT, RO, SI
Article 16(5) – Liquidity buffer	BE, BG, (33) CY, DK, EE, EL, FI, FR, IE, IT, LT, NL, PL, PT, SE, SI (33)	AT, CZ, DE, ES, HU, LU, RO, SK
Article 16(6) – Liquidity buffer	AT, DK, ES, LT, PT, RO, SK	BE, BG, CY, CZ, DE, EE, EL, FI, FR, HU, IE, IT, LU, NL, PL, SE, SI
Article 17(2) – Extendable maturities	AT, BE, BG, (33) CY, CZ, DE, DK, EE, EL, ES, FI, FR, HU, IE, IT, LT, NL, PL, PT, SE, SI, (33) SK	LU, RO
Article 20(2) – Special administrator	BE, BG, CY, CZ, DE, DK, (30) EE, EL, ES, FI, FR, HU, IE, LT, LU, PL, PT, RO, SI, SK,	AT, IT, NL, SE
Article 23 – Administrative penalties	DE, DK, EE, FI, RO, SE	AT, BE, BG, CY, CZ, EL, ES, FR, HU, IE, IT, LT, LU, NL, PL, PT, SI, SK
Article 30(1)-(2) – Transitional measures	(1) BE, CY, CZ, DE, DK, EE, EL, FI, FR, HU, IT, LU, NL, PL, PT, RO, SE, SK (2) BE, CY, CZ, EL, FI, HU, NL, PL, PT, SE, SK	(1) AT, BG, ES, IE, LT, SI (2) AT, BG, DE, DK, EE, ES, FR, IE, IT, LT, LU, RO, SI

1.5.2 DISCRETION RELATED TO THE CRR

Figure 7: Overview of discretions applied by EU Member States in the CRR

Article	Yes	No
Article 129(1a)(c) – CQS 3 derivatives	BG, (33) EL, ES, FR, HU, IT, NL, (33) PL, (33) PT, RO	AT, BE, CY, CZ, DE, DK, EE, FI, IE, LT, LU, SE, SI, SK
Article 129(3a) – Min. over-collateralisation	AT, DE, DK, FI, HU, IE, LU, SE, SI	BE, BG, CY, CZ, EE, EL, ES, FR, IT, LT, NL, PL, PT, RO, SK

2. COVER ASSETS

KEY TAKEAWAYS OF THIS CHAPTER

OVERVIEW

The rules governing the characteristics of the assets that are eligible as collateral for the covered bond (the cover assets) are at the very core of the EU covered bond framework. The cover assets should be of the highest quality and hence provide high safety to the instrument. The EBA analysed thoroughly the soundness of the provisions related to cover assets to assess the merit for policy intervention in the interest of EU market harmonisation and consumer protection. The main regulatory areas under scrutiny are those governing the eligibility of the cover assets, their composition in the cover pool, their geographical location, and the functioning of intragroup and joint funding covered bonds structures.

Eligible cover assets (Article 6 of the CBD)

The CBD currently allows for three different types of assets in the cover pool: those under Article 129 of the CRR, and those that fall outside its scope but are either high quality or in the form of claims on public undertakings, both of them subject to additional requirements. The definition of the latter two is largely at the discretion of Member States. The EBA has identified in this discretion a possible source of concerns in terms of (a) regulatory harmonisation, (b) comparability of cover assets across jurisdictions, and (c) a lack of supervisory experience with these largely unused assets. For this reason, **the EBA recommends restricting eligibility to those assets that fall within the scope of Article 129 of the CRR**.

Composition of the cover pool (Article 10 of the CBD)

Cover pools are usually composed of one primary type of asset (for instance, mortgages), which is often the dominant and/or the only one in the pool, and one or more types of substitution assets. The CBD adopts a clear principle-based approach in that it leaves flexibility to Member States to define of primary and substitution assets. At the same time, the EBA acknowledges that having full knowledge of the characteristics of the cover assets is of utmost importance to the investor, so they can clearly identify the type of collateral. For these reasons, **the EBA supports the current national flexibility** relating to defining primary and substitution assets but also **recommends that these definitions be always sufficiently specified in the legislation** and hence **clearly readable to the investor.**

Geographical location (Article 7 of the CBD)

The CBD allows cover assets to be located in a jurisdiction outside the EU/EEA. Some Member States exercise this discretion but mostly restrict eligible jurisdictions to some but not all third countries and have limitations as to their relative amount in the pool. In any case, the CBD requests that the rules governing enforceability of such assets offer the same degree of protection as domestic assets. The EBA finds these provisions to be sufficiently robust.

Intragroup pooled covered bond structures and joint funding (Article 8 and Article 9 of the CBD)

The CBD allows Member States to implement flexible structures for issuers – intragroup and joint – to support broader access to the covered bond market. In particular, it allows covered bonds issued by an institution within the same scope of consolidation to be used as cover assets beyond the limitations of Article 129(1a) of the CRR, as well as to use eligible cover assets originated by third parties and purchased by the issuer to be used as cover assets. As to this last permission, the CBD allows the discretion to use assets that are acquired via means other than purchase, or that are not originated by credit institutions. However, **the EBA** notes that it is not clear whether these two discretions can be exercised at the same time and therefore **recommends the COM to clarify the hierarchy of the related provisions**.

2.1 Overall introduction

This chapter gives an overview of national legal frameworks and of the identified issues (and related recommendations) on the following topics related to cover assets:

- eligible cover assets (Article 6 of the CBD);
- composition of the cover pool (Article 10 of the CBD);
- geographical location (Article 7 of the CBD);
- intragroup pooled covered bond structures and joint funding (Article 8 and Article 9 of the CBD).

As a complement to its analysis, the EBA conducted a detailed assessment of the differences and similarities between the CBD and the CRR in relation to the treatment of cover assets. The aim was to identify sources of discrepancy and evaluate whether there is a potential for harmonisation or instead if the deviations are justified by distinct policy objectives. This analysis will be covered in Chapter 13.

2.2 Eligible cover assets

2.2.1 INTRODUCTION AND LEGAL REFERENCE

The overarching principle of the CBD in laying down the list of minimum criteria for the eligibility of cover assets is to ensure that covered bonds are recognisable, comparable, and treated consistently in the different national frameworks from the point of view of asset quality and instrument type.

Article 6(1) of the CBD, which sets the eligibility criteria for the assets that can contribute to the cover pool, allows three categories:

- Article 6(1)(a): Assets eligible under Article 129(1) of the CRR, provided issuing institutions meet additional requirements (Article 129(1a) to (3));
- Article 6(1)(b): High-quality cover assets that can ensure a claim for payment (Article 6(2)) and are secured by collateral assets fulfilling specific requirements (Article 6(3));
- Article 6(1)(c): Loans to or guaranteed by public undertakings, provided additional requirements are met (Article 6(4)).

It should be noted that only that first category can be eligible for the 'European Covered Bond (Premium)' label and hence be granted a preferential treatment for capital and liquidity requirements. However, the CBD also allows the second and the third categories to be eligible for the 'European Covered Bond' label, but subject to additional requirements detailed in Article 6(2) to (4) of the CBD. These additional requirements aim primarily at ensuring the enforceability of the claims, and at setting standards (albeit minimum) in terms of clarity, comparability and consistency.

As to the first category, Article 129(1) of the CRR defines a list of seven categories of assets (Article 129(1)(a) to (g) of the CRR). In substance, these assets are of three main types: mortgages (or guaranteed loans) on residential real estate (RRE) and commercial real estate (CRE), exposures to public administrations (in the EU and outside the EU with additional credit quality requirements) and – subject to limits of up to 15% only – exposures to credit institutions. Additionally, the CRR also recognises loans secured by maritime liens on ships, which are not widely used at the EU level but are well-established in a few Member States.

For these assets to be eligible for the 'European Covered Bond (Premium)' label, the CRR requires credit institutions to comply with the rest of the requirements of the said Article, and in particular with Article 129(1a) to (3) of the CRR. These requirements establish limits on the maximum share of exposures towards credit institutions in the cover pool (1a). ([35]) It also specifies the functioning of the LTV limits on a loan-by-loan basis for residential property, commercial immovable property and maritime liens on ships. Lastly, the CRR specifies that immovable property and ships have to comply with the requirements of Article 208 of the CRR in terms of specific legal aspects, monitoring of property valuation and adequacy of the insurance against the risk of damage. ([36])

As to the second category, the CBD allows 'high-quality cover assets' as eligible for the 'European Covered Bond' label if they fall in one of three sub-categories:

- Exposures with 'high quality physical collateral', subject to 'valuation standards that are generally accepted' and to the presence of a 'public register that records ownership of and claims on those physical collateral assets'. Depending on the national transposition, this may also include aircrafts, ships and boats or railway items and rolling stocks. However, the majority of these assets are simply mortgages that do not comply with the requirements of Article 129 of the CRR, for instance because of high LTV.
- 'High quality cover assets' exposures to a counterparty with 'tax-raising powers'. This would typically be the case of exposures to central governments (or RGLA that are treated as exposures towards a central government, as in Article 115(2) of the CRR). This does not include any requirements on the credit quality step or restrictions to the geographical situation and may entail a significantly higher risk than similar asset types under Article 129(1)(a) and (b) of the CRR.
- 'High quality cover assets' exposures to a counterparty which is 'subject to ongoing supervision of its operational soundness and financial solvability'. This would typically be the case for exposures to credit institutions and insurance undertakings, which are both subject to prudential requirements and supervision. This does not include any formal requirements on the credit quality step, neither to the nature of the entity by itself, and is likely to ensure a significantly higher risk than the exposures to credit institutions listed under Article 129(1)(c) of the CRR.

As to the third category, the CBD allows exposure to public undertakings subject to a 10% minimum over-collateralisation requirement. The public undertakings should provide public services on the basis of a form of concession contract, be subject to public supervision and have sufficient revenue raising powers, by way of the power of increasing fees, by way of receiving grants on a statutory basis or by way of having entered into a 'profit and loss transfer agreement with a public authority'. These requirements aim to ensure a level of credit enforceability close to the one of a

([35]) These limits do not apply to the use of covered bonds as eligible collateral under intragroup pooled covered bond structure as allowed by Article 8 of the CBD.

([36]) Article 6(6) of the CBD also requires that credit institutions issuing covered bonds have in place procedures to monitor that the physical collateral are adequately insured against the risk of damage, for cover assets under both Article 129(1) of the CRR and Article 6(1)(b) of the CBD.

public administration, without having the powers to increase tax and the ultimate recourse of the State. ([37]) The CBD recognises the intrinsic higher-level risk of such exposures by requiring a statutory level of over-collateralisation of 10%, in contrast with the 0% that is generally required for the 'European Covered Bond'.

2.2.2 THE ELIGIBLE COVER ASSETS FRAMEWORKS IN THE EU

According to the questionnaire, about half of the Member Stares only allow assets falling under Article 6(1)(a) of the CBD, while the rest declared to also allow assets falling under Article 6(1)(b). Only six countries allow assets that fall under Article (6)(1)(c). A thorough overview of the results can be found in Figure 8 and Figure 9.

Despite their eligibility, in most Member States assets falling into (b) and (c) are rarely used as cover assets, and a vast majority of the covered bonds backed by these types of assets in the market are the outstanding residual of old long-maturity issuances. The survey addressed to the market participants also confirmed that assets under Article 6(1)(a) of the CBD are the norm in the market, being the preferred among investors in light of the full alignment with the CRR and hence with the compatibility with the 'European Covered Bond (Premium)' label.

([37]) Typically, this category would include exposures towards public undertakings having a concession for the exploitation of an infrastructure (e.g. a motorway).

Figure 8: Overview of the different national legislation frameworks on eligible cover assets as per Article 6(1) of the CBD

Member State	Do you allow Article 129 of the CRR only?	What is 'high quality cover assets' of Article 6(1) (b) of the CBD?	In case of physical assets serving as collateral, does a public register exist?	Do you allow Article 6 (1)(c)?
Austria	No	No specific definition	Cover register (not public)	No
Belgium	Yes	-	-	No
Bulgaria	Yes ([38])	-	-	No
Cyprus	No	No specific definition	Land register (cadastre)	Yes (not used)
Czechia	No	Specific list (claim from mortgage loan, claim against or guaranteed by OECD member state, central bank MDB, funds of the issuer on an account kept by management companies an investment funds and rights from a derivative)	Land register (cadastre)	Yes (not used)
Denmark	No ([39])	Assets eligible pursuant to Article CRR 129(1), but where the requirements of paragraph 1a to 3 of Article 129 are not fulfilled	Register for immovable property	No
Estonia	Yes	-	-	No
Finland	Yes	-	Yes ([40])	No
France	Yes	-	-	No
Germany	No	Claims secured by registered lien or mortgage on aircraft (for aircraft Pfandbriefe)	Register in Germany and required register in overseas territories	No
Greece	No	Not specified yet, a decision from the Bank of Greece is still required	No, the BoG has not allowed yet these types of assets	No

([38]) Eligible cover assets could also include internally issued covered bonds which in turn are backed by assets eligible under Article 129 of the CRR.

([39]) Article 6(1)(b) of the CBD is only allowed to capture mortgages that do not meet the full requirements of Article 129 of the CRR (such as LTV-limits), thus technically falling under Article 6(1)(b) of the CBD.

([40]) In the sense that even Article 129 of the CRR assets are subject to public registration.

Member State	Do you allow Article 129 of the CRR only?	What is 'high quality cover assets' of Article 6(1)(b) of the CBD?	In case of physical assets serving as collateral, does a public register exist?	Do you allow Article 6 (1)(c)?
Hungary	Yes	-	Online land office register ([37])	No
Ireland	Yes	-	-	No
Italy	Yes	-	-	No
Lithuania	Yes	-	-	No
Luxembourg	No	RRE and CRE, aircraft, ships and boats, railway items	Land register (cadastre), register for aircrafts and boats	Yes (conditions of Article 6(1)(c) replicated in national law; an undertaking as defined in letter (b) of Article 2 of Commission Directive 2006/111/EC of 16 November 2006)
Netherlands	Yes	-	-	-
Poland	Yes	-	Land and mortgage register ([37])	No
Portugal	No	Generic definition (and not used in practice)	Land Register and Simplified Ships and Boats Register	Yes (conditions of Article 6(1)(c) replicated in national law but no specific definition)
Romania	No	Specific list (close to the CRR one)	Land Register and National Register of Movable Property	No
Slovenia	Yes	-	-	No
Slovakia	No	Mortgage loan with an LTV of up to 100% (not used in practice)	Land register (cadastre)	Yes (not used in practice but there is a definition in the national legislation)
Spain	No	No specific definition	No specific definition	Yes (no specific definition)
Sweden	Yes	-	-	No

Figure 9: Overview of the different national legislation frameworks on eligible cover assets as per Article 129(1) of the CRR

EU Member State	Exposures to central governments [...] as defined in Article 129 (1)(a) of the CRR	Exposures to third country central governments [...] as defined in Article 129 (1)(b) of the CRR	Exposures to credit institutions as defined in Article 129(1)(c) of the CRR	Loans secured by residential property as defined in Article 129 (1)(d) of the CRR	Residential loans fully guaranteed as defined in Article 129(1)(e) of the CRR	Loans secured by commercial property as defined in Article 129 (1)(f) of the CRR	Loans secured by maritime liens on ships as defined in Article 129(1)(g)
Austria	Yes	Yes	Yes	Yes.	Yes	Yes	Yes
Belgium	Yes	Yes	Yes, but only CQS 1 and CQS 2 and short-term exposures or deposits or derivatives	Yes, but located within EEA + under construction max 15% + compliance EBA Q&A 2015_2304	No	Yes, but within EU/EEA, under construction not allowed, max 60% LTV	No
Bulgaria	Yes	Yes, with additional limits on composition	Yes	Yes	Yes, but if in third country: max 20% principal	Yes, but if in 3rd country: max 20% principal, allow up to 70% LTV	Yes
Cyprus	Yes	Yes	Yes	Yes, but CRE or RRE limited to 10% of the cover pool, max 70% LTV soft limit	Yes	Yes, but limit LTV is 50%	Yes, but value not more than 50%, total loan cannot be larger than 5% of the cover pool
Czechia	Yes	Yes	Yes	Yes, but located in EU + nominal value mortgage loan max 100% MLV	Yes	Yes., but within EU/EEA	No
Denmark	Yes [41]	Yes	Yes	Yes, but loans under construction are allowed but during the construction phase, there needs to be another asset in the cover pool which meets 129 to cover the coverage	No	Yes, but agricultural, forestry, horticulture – max LTV limit of 70%, undeveloped land – loan limit of 40%, rest is 60% LTV	Yes

[41] Only to public authorities or primary guarantee from public authority.

EU Member State	Exposures to central governments [...] as defined in Article 129 (1)(a) of the CRR	Exposures to third country central governments [...] as defined in Article 129 (1)(b) of the CRR	Exposures to credit institutions as defined in Article 129(1)(c) of the CRR	Loans secured by residential property as defined in Article 129 (1)(d) of the CRR	Residential loans fully guaranteed as defined in Article 129(1)(e) of the CRR	Loans secured by commercial property as defined in Article 129 (1)(f) of the CRR	Loans secured by maritime liens on ships as defined in Article 129(1)(g)
Estonia	Yes ([42])	Yes, but only as substitute collateral	Yes	Yes, but loans granted to a natural person only (SME excluded?), no default at time of inclusion	No	Yes	No
Finland	Yes	Yes	Yes	Yes	No	Yes	No
France	Yes	Yes	Yes	Yes, but located in EU/EEA or third country with CQS 1, for loans under construction, the value is capped at 80% of completion value	Yes (very high proportion of loans)	Yes, but located in EU/EEA or third country with CQS 1, max 60% LTV	No
Germany	Yes	Yes, but limited to specific jurisdictions (EU/EEA, CA, CH, JP, UK, US)	Yes, but limited to specific jurisdictions (EU/EEA, CA, CH, JP, UK, US), only in presence of equivalence, only CQS 1 and CQS 2, only if not part of the group of the issuing bank, if not subject to CRD, only if regime is equivalent to domestic one	Yes, but eligible jurisdictions EA/EEA, AU, CA, CH, JP, NZ, SG, UK, and US, property under construction allowed up to 10%, ([43]) MLV soft limit is 60% for coverage	No	Yes, but eligible jurisdictions EA/EEA, AU, CA, CH, JP, NZ, SG, UK, and US, AU, NZ and SG, property under construction allowed up to 10%, ([40]) MLV soft limit is 60% for coverage	Yes, but minimum amortisation loans, maximum useful life of ship of 20 years
Greece	Yes	Yes, but no CQS2, even for the share below 20% of the cover assets	Yes	Yes, but located in the EU – proof to BoG on the lien, under construction (com. and res. is possible up to 10% of the cover pool	Yes	Yes, but located in the EU – proof to BoG on the lien, under construction (com. and res. is possible up to 10% of the cover pool)	Yes

([42]) Only as substitute collateral.

([43]) Not yet capable of producing income. It includes building land, with a sub-limit of 1%.

EU Member State	Exposures to central governments [...] as defined in Article 129 (1)(a) of the CRR	Exposures to third country central governments [...] as defined in Article 129 (1)(b) of the CRR	Exposures to credit institutions as defined in Article 129(1)(c) of the CRR	Loans secured by residential property as defined in Article 129 (1)(d) of the CRR	Residential loans fully guaranteed as defined in Article 129(1)(e) of the CRR	Loans secured by commercial property as defined in Article 129 (1)(f) of the CRR	Loans secured by maritime liens on ships as defined in Article 129(1)(g)
Hungary	Yes	Yes, but only EIB, IBRD, CEB and EBRD are allowed	No	Yes	No	Yes	No
Ireland	Yes	Yes	Yes	Yes	No	Yes	No
Italy	Yes	Yes	Yes	Yes, but located in EU/EEA + CH and direct reference to Article 129(1)(d)	Yes	Yes, but scope EU/EEA, maximum LTV 70%	Yes
Lithuania	Yes	Yes, but only CQS 1, even below 20% of the cover assets	Yes	Yes	Yes	Yes, maximum LTV 60%	Yes
Luxembourg	Yes	Yes	Yes	Yes, but movable property and immovable under construction max 20% cover pool	Yes	Yes, LTV up to 70%, located in the EU/EEA + OECD + up to 50% in states with credit quality 1 + up to 10% in states with credit quality 2	Yes
Netherlands	Yes, only if located in the EU/EEA	Yes, only if located in the EU/EEA	Yes, only if located in the EU/EEA	Yes, only if located in the EU/EEA	Yes, only if located in the EU/EEA	Yes, only if located in the EU/EEA	
Poland	Yes, with specific requirements (encumbrance and opinion from the regional court of auditors [44] for guarantees by local government)	Yes, but no exposures to governments and central banks subject to foreign debt restructuring within the last 5 years	Yes, but only in relation to derivatives	Yes, but must be located in PL, under construction allowed up to 10%, max hard limit 100% MLV at origination or purchase date, not allowed property where the exploitation is not of a permanent nature	No	Yes, must be located in PL, under construction allowed up to 10% of cover assets	No

[44] 'Regionalna izba obrachunkowa' which is an independent state body established for the control and supervision of local governments.

EU Member State	Exposures to central governments [...] as defined in Article 129 (1)(a) of the CRR	Exposures to third country central governments [...] as defined in Article 129 (1)(b) of the CRR	Exposures to credit institutions as defined in Article 129(1)(c) of the CRR	Loans secured by residential property as defined in Article 129 (1)(d) of the CRR	Residential loans fully guaranteed as defined in Article 129(1)(e) of the CRR	Loans secured by commercial property as defined in Article 129 (1)(f) of the CRR	Loans secured by maritime liens on ships as defined in Article 129(1)(g)
Portugal	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Romania	Yes	No	Yes	Yes, but within EU/EEA, under construction is not allowed	No	Yes, but EU/EEA and LTV max 60%	No
Slovenia	Yes, with some types of exposures only as primary and substitution assets	Yes, but only as substitution assets, debt securities of EIB, EBRD and MDBs corresponding to CQS1	Yes, but only debt securities of CQS 1 and CQS 2, and derivatives (also CQS 3)	Yes, max 80% LTV, within EU/EEA, under construction must not exceed 5% of cover assets where the land register procedure is still in place, not exceed 10%, group of connected clients must not exceed 20% of cover assets	No	Yes, max 60% LTV, within EU/EEA, commercial loans must not exceed 20% of cover assets where the land register procedure is still in place up to 10% cover assets, group of connected clients must not exceed 20% of cover assets	No
Slovakia	Yes	Yes, but only as substitution assets, maximum of 10% or 20% depending on the programme	Yes, only CQS 1 and CQS 2, only deposits with a bank	Yes, but only in SK, under construction allowed but the bank must determine itself risk policy	No	Yes, only in SK, but not used in practice	No
Spain	Yes	Yes	Yes	Yes, but under construction only within the meaning of the EBA Q&A	No	Yes, but under construction not allowed	No
Sweden	Yes	No	Yes	Yes, but within EU/EEA, max 80% LTV	No	Yes, but within EU/EEA, max 60% LTV (soft limit)	No

2.2.3 CONCLUSIONS AND POLICY RECOMMENDATIONS

Among the consequences of the scarce utilisation of assets allowed under Article 6(1)(b) and Article 6(1)(c) of the CBD, ([45]) particular sources of concern are the lack of proper supervisory experience, and the fact that safeguards for the investor are not always clearly outlined in national law (for instance, regarding assets under (b), the availability and the comparability across jurisdictions of public registries for tangible assets). In addition, the definition of high-quality assets is not always sufficiently defined in national law, and given the poor level of harmonisation, their quality is hardly comparable across different jurisdictions.

The EBA acknowledges that, in many jurisdictions the eligibility of these classes of assets in the national law resulted from a translation of the CBD that from one side may serve the purpose of leaving the maximum degree of flexibility for future issues, but at the same time is not motivated by an established market standard.

An argument in favour of the elimination of Article 6(1)(b) and Article 6(1)(c) of the CBD is the limited market impact that such an elimination would have. Indeed, issuers would not be impeded from issuing bonds secured by these assets under legal frameworks outside the scope of the (national transposition of) the CBD, as they could continue to do so by using mortgages or public sector entities of a lesser quality, which do not meet the requirements of the CRR on LTV or on credit quality step. This would ensure market continuity and allow institutions to fund themselves with lower quality assets if necessary. The same holds true for other exotic asset classes, for which it is more appropriate to build a track-record outside a framework where potential failure might have adverse spill-over effects on established covered bonds.

In addition, the EBA notes that some of the assets currently permitted under Article 6(1)(b) and (c) of the CBD are similar in nature to those already outlined in the CRR. For instance, in case of movable properties like maritime liens, these assets are allowed in all Member States by way of Article 129(1) of the CRR, even if issuances at the European level are very limited. ([46]) From a risk perspective, concerns about this type of assets are generally low, given that conditions for eligibility are generally more stringent, both in terms of the level of statutory over-collateralisation and of the valuation methodology. ([47])

However, the EBA has also evaluated arguments in favour of maintaining the *status quo*. A round of consultation with industry representatives was held to acquire a better understanding of the actual merits of the utilisation of such assets, especially in a forward-looking perspective. The industry confirmed that, whilst as of now there is little interest for such assets, the market perceives this degree of flexibility as a tool to develop other types of secured instruments in the future. For instance, importance has been given to the future need for the financing of social and government programmes of various type, against collateral that may not fulfil the criteria of the CRR, ([48]) but whose quality may still justify the label of 'European Covered Bond'.

In terms of innovation, the choice between the two options will certainly have effects. If the eligibility of these assets were to be removed, innovation would be left entirely to the market, i.e. outside the scope of the CBD. *Vice-versa*, if the CBD were to maintain the eligibility, the EBA is of the opinion that it shall be paired with a strengthened definition of

([45]) As previously mentioned, although the list of assets that Member States allow under category (b) is usually wide (immovable properties such as residential, industrial, commercial, residential for commercial purposes, and movable properties such as aircrafts, ships and boats, railway items, rolling stocks,...), in practice the use of these rare assets is almost exclusively limited to those falling in the category of mortgages that do not comply with Article 129 of the CRR (mostly because of high LTV).

([46]) The institutions using such cover assets are essentially located in Denmark and Germany.

([47]) For instance, in Germany, the covered bonds with maritime liens as cover assets are subject to a regulatory minimum of 5% over-collateralisation with an observed level of around 30%. Additionally, these assets are subject to the mortgage lending valuation methodology.

([48]) For instance, because of higher LTV ratios, or because of hybrid public-private structures investing in such social programmes not fulfilling the definition of public undertakings.

high-quality (possibly in terms of a closed list of eligible assets) and more stringent safeguards. Therefore, market innovation would be in this case entirely in the hands of the legislator, by means of subsequent updates to the list or safeguards.

Recommendation 1. *On the eligibility for cover purposes of assets as per Article 6(1)(b) and Article 6(1)(c) of the CBD.*

The EBA recommends the outright removal of the possibility to use as coverage assets provided for in Article 6(1)(b) and 6(1)(c) of the CBD, therefore restricting the eligible assets to those provided for in Article 129(1) of the CRR.

2.3 Composition of the cover pool

2.3.1 INTRODUCTION AND LEGAL REFERENCE

Article 10 of the CBD requires Member States to lay down rules on the composition of the cover pool and set criteria – where relevant – for the inclusion of different classes of assets as the primary assets constituting the pool.

The CBD grants a considerable degree of flexibility, which can be justified by several factors, such as the existence of different covered bond models across Europe (e.g. specialised covered bond institutions versus universal banks), the flexibility granted by Article 6 of the CBD in terms of the definition of the perimeter of eligible cover assets, as well as differences stemming from the exact definition of primary and substitution assets adopted by Member States.

The definition of primary and substitution assets granted by Article 3(12) and Article 3(13) of the CBD is intentionally very high-level: primary assets are defined as 'dominant cover assets that determine the nature of the cover pool', while for substitution assets only a negative definition is used (i.e. all assets other than primary assets).

2.3.2 THE COVER POOL COMPOSITION FRAMEWORKS IN THE EU

According to the questionnaire, the vast majority of Member States have in place rules on cover pool composition. For those countries that do not impose limits on the composition it is market practice (albeit not always legally required) to use only one type of asset as the main asset in the cover pool. A thorough overview of the results can be found in Figure 10.

The lack of clear definitions in Article 3 of the CBD led to a high level of heterogeneity across countries in terms of definition of primary and substitution assets and, as a result, in terms of specific limits to their use. As a matter of fact, some countries do not have a formal definition, others consider primary asset the dominant asset of the cover pool, and others have a specific list of cover assets which can be a primary asset but do not specify whether only one of these can be the dominant asset in a cover pool.

Where limits are imposed by national regulatory frameworks they are defined across multiple dimensions, such as the percentage of assets that must be primary, the maximum percentage of substitution assets, limits on CQS and derivatives, and limits on asset types.

Additionally, Member States have different approaches regarding the granularity level in the identification of primary asset classes. For instance, some consider RRE and CRE mortgages separately, while for others the two constitute the same asset type (i.e. they are both considered mortgages). Where RRE and CRE are defined separately, limits may be imposed on the proportion of CRE in the pool.

For the same reason, the definition of substitution asset is even more uncertain. Some Member States consider substitution assets, as those cover assets that are included in the cover pool but are not the dominant ones (therefore, cover assets which can be a primary asset but are not the dominant one in the cover pool can also serve as a substitution asset). Others have a specific list of cover assets which can only be included as substitution assets.

Finally, the EBA noted that mixed cover pools of different primary asset types (for example loans to central governments and immovable property) can be present in jurisdictions that do not specify any rules on composition, but there are also Member States where these practices are explicitly allowed. It is difficult to assess what asset should be considered the dominant asset, when there is a variety of assets (mortgages, public sector loans, etc.) in mixed cover pools and a Member State does not require dominant asset specification. Although this is a difficulty, the EBA understands it is not a widespread issue.

Figure 10: Overview of the different national legislation frameworks on the composition of the cover pool

Member State	Rules on the composition of the CP	Definition of primary assets	Definition of substitution assets	Limits on the composition (primary or substitution assets) (49)	Additional requirements/rules
Austria	Yes	Yes, CBD definition	Yes, CBD definition	Yes, primary assets at least 85% of the coverage requirement (50)	-
Belgium	Yes	Yes, depending on the type of covered bond (either public sector loans, RRE, or CRE) (51)	Yes, CBD definition	Yes, primary assets at least 85% of the coverage requirement	Limits for specific types of loans (52)
Bulgaria	Yes	Yes, Article 129 of the CRR items (except for exposures to credit institutions)	Yes, exposures to credit institutions	Yes, primary assets at least 85% of the coverage requirement	Only one primary asset class in the same cover pool (53)
Cyprus	Yes	Yes, CBD definition	Yes, CBD definition	Yes, primary assets at least 85% of the coverage requirement	-
Czechia	Yes	-	-	-	-
Denmark	No (54)	-	-	-	-

(49) To be intended as additional limits to the ones set forth by Article 129 of the CRR.

(50) In addition, the topping-up to 100% of the coverage requirement may only occur using substitution assets pursuant to Article 129 of the CRR within the limits determined therein.

(51) The main cover asset type should be one of the following: loans secured by residential immovable property, loans secured by commercial immovable property, loans to or guaranteed by central banks or central governments.

(52) Loans secured by RRE under construction should represent maximum 15% of cover assets. Loans to or secured by RGLA or PSE equivalent to the central government, but with CQS 2, should not represent more than 20% of the nominal amount of the covered bonds. Loans to credit institutions should not represent more than 15% of the nominal value of the covered bonds, and for credit institutions with a CQS 2 they should not represent more than 10% of the nominal value of covered bonds.

(53) Subject to authorisation by the competent authority, the issuing bank may also include a different type of primary assets in the cover pool that have similar structural features, lifetime and risk profile.

(54) It is only prohibited that the same cover pool includes both exposures collateralised by real estate and ship liens.

Member State	Rules on the composition of the CP	Definition of primary assets	Definition of substitution assets	Limits on the composition (primary or substitution assets) ([49])	Additional requirements/rules
Estonia	Yes	Yes, depending on the type of covered bond ([55])	Yes, exposures to central banks/governments and credit institutions	Yes, primary assets at least 85% of the coverage requirement	-
Finland	Yes	-	-	Yes. Substitution assets accounting for up to 20% of the total nominal value of the cover pool.	Commercial property loans accounting for up to 10% of the total nominal value of the cover pool, unless otherwise agreed in the terms of the bond.
France	No	Yes, loans secured by immovable property and exposures to public entities ([56])	Yes, exposures to credit institutions as defined in Article 129(1)(c) of the CRR	-	-
Germany	Yes	Yes, depending on the type of covered bond (mortgage, public sector, ship, aircraft)	Yes ([57])	Yes, detailed and depending on the type of covered bond ([58])	Yes, qualitative requirements (risk management system, including limit system)
Greece	Yes	Yes, CBD definition	Yes, exposure to credit institutions, as defined in 129(1)(c) of the CRR	Yes, for primary assets: specific percentages of RRE/CRE; for substitution assets: limit of 15% of CB	-
Hungary	Yes	Yes, mortgage loans	Yes, exposures to central bank/government, covered bonds	Yes, primary assets and derivatives at least 80% of the coverage requirement	Yes, limits on derivative assets (12%)

([55]) Only mortgages in the case of 'mortgage covered bonds', while several types of cover assets are allowed for 'mixed covered bonds'.

([56]) The eligible cover assets are mainly loans secured by immovable property (mortgage or guaranteed loans, as in Article 129(1)(d) and (e) of the CRR) and exposures to public entities (Article 129(1)(a) and (b) of the CRR).

([57]) Exposure to credit institutions, close-out amounts for derivatives, as well as (only for mortgage, ship and aircraft covered bonds) securities that are eligible primary assets for public-sector covered bonds.

([58]) For instance, an overall limit of 20% for substitution assets (but assets used to meet voluntary over-collateralisation can be included beyond this limit), with additional limits for exposures to credit institutions and close-out amount for derivatives based on counterparty CQS (15%, 10%, 8%).

Member State	Rules on the composition of the CP	Definition of primary assets	Definition of substitution assets	Limits on the composition (primary or substitution assets) (49)	Additional requirements/rules
Ireland	Yes	Yes, depending on the type of covered bond (mortgage, commercial mortgage, public sector)	Yes, exposures to credit institutions	Yes, commercial property cannot be more than 10%	Yes, specific requirements for designated mortgage/commercial mortgage/public credit institutions
Italy	No	-	-	-	-
Lithuania	Yes	Yes, Article 129 of the CRR items (except for exposures to credit institutions)	Yes, exposures to central bank/government, credit institutions	Yes, primary assets and derivatives at least 80% of the coverage requirement	-
Luxembourg	Yes	Yes, CBD definition	Yes, cash, exposures to central bank/ government, credit institutions, covered bonds issued under intragroup pooled covered bond structures, commitments made in any form by public entities	Yes, primary assets and derivatives at least 80% of the coverage requirement	-
Netherlands	Yes	Yes, CBD definition	Yes, CBD definition	Yes, primary assets and derivatives at least 80% of the coverage requirement	-
Poland	Yes	Yes, depending on the type of covered bond (mortgage, public sector)	Yes, exposures to central bank/government, credit institutions	Yes, primary assets at least 85% of the coverage requirement	-
Portugal	Yes	Yes, CBD definition	Yes, CBD definition	Yes, qualitative (59)	RRE and CRE considered as single primary asset class, limits to variation of the initial proportion of different assets

(59) The proportion should not vary significantly from the inception, except for reasons relating to the amortisation profile of the cover assets.

Member State	Rules on the composition of the CP	Definition of primary assets	Definition of substitution assets	Limits on the composition (primary or substitution assets) (49)	Additional requirements/rules
Romania	Yes	Yes, Article 129 of the CRR items	Yes, CBD definition	Primary assets at least 70% of the book value of the cover pool	-
Slovenia	Yes	Yes, depending on the type of covered bond (mortgage, municipal)	Yes, exposures to central bank/government, credit institutions, EIB, EBRD and MDBs	Yes, substitution assets max 20% of cover assets	Yes, limits on commercial mortgage loans (max 20% of cover assets) and some other specific limits (group of connected clients, land register procedure in progress, RRE under construction)
Slovakia	Yes	Yes, CBD definition	Yes, exposures to central bank/government, credit institutions	Yes, primary assets at least 90% or 80% depending on the type of covered bond	-
Spain	Yes	Yes, CBD definition	Yes, exposures to central bank/government, credit institutions	Yes, primary assets at least 90% of the coverage requirement	-
Sweden	Yes	No (60)	No	Yes, commercial property cannot be more than 10%	-

(60) Dominant asset classes are loans secured by residential property or property used for agricultural or forestry purposes.

2.3.3 FEEDBACK FROM THE INDUSTRY

Opinions on the factors driving the composition of cover pools are aligned across countries as well as across categories of respondents. Analysts and investors agree that cover pool composition influences pricing, but that it only comes after the issuer's rating, country-specific characteristics and sovereign rating caps. Markets strongly prefer (RRE) rather than (CRE), and this translates into a higher premium paid by the issuer of bonds whose cover pool is composed by CRE. Quality monitoring is done mainly via checks on the LTV ratio and over-collateralisation levels.

Issuers largely follow market demand in that they mostly use RRE as underlying assets, thanks to higher ratings and to simplicity of handling a single class of assets. Repo eligibility is also a crucial factor in the choice. For this reason, cover pools tend to be very stable in composition (though there has been a long-term trend featuring a change from sovereign to mortgage), and to be exclusively composed by RRE. Either because of national law requirements or business decisions based on simplicity and cost reductions, single covered bond programmes are assigned a pool composed by a single type of asset (RRE). ([61]) Respondents also remarked that the inclusion of derivatives in the cover pool (either for micro or macro hedging purposes, or both) tend to be very heterogeneous across countries and even across institutions.

2.3.4 CONCLUSIONS AND POLICY RECOMMENDATIONS

The EBA focused their analysis on the differences across Member State regulations regarding the definitions of primary/substitution assets and on the rules in place for cover pool composition.

As it emerged from the questionnaire to NCAs, the main issue at stake concerns the need to ensure that regulators sufficiently determine the characteristics that a dominant asset must have to qualify as primary in accordance with Article 10 of the CBD, considering that in some cases national frameworks do not provide a proper definition of primary and/or substitution asset. The overarching principle in guiding definition clarity is that investors shall have the possibility to distinguish the characteristics of different covered bonds depending on the dominant assets of the respective cover pools.

However, the EBA acknowledges that the high flexibility granted by the CBD is appropriate in light of the many differences across Member States for what concerns covered bond models and the perimeter of eligible cover assets.

Additionally, the EBA is of the view that maximum flexibility shall be kept also in terms of the eligibility of assets for the purpose of the definition of dominant assets, as well as in their authorised combination (for instance, whether RRE and CRE can be considered as a single class). This view is supported when considering the issuance of high quality products (such as 'European Covered Bond (Premium)'), that Article 129 of the CRR already poses limitations to the use of certain categories and/or amounts of assets in the pool, and that Article 14 of the CBD already demands disclosure on the type of asset used.

([61]) With notable exception in some countries. In Germany it is a very well-established business practice to mix RRE and CRE.

Recommendation 2. *On the rules governing the composition of the cover pool.*

While stressing the principle-based nature of Article 10 of the CBD, the EBA recommends Member States to ensure full compliance with the said Article by laying down – if not present already in their national legislation – the concrete principles defining the distinctive characteristics of dominant assets. This is so the nature of the covered bond which, sold to the investor, can be effectively determined. Such characteristics shall be fully reflected in the disclosure information.

2.4 Geographical location

2.4.1 INTRODUCTION AND LEGAL REFERENCE

Article 7 of the CBD sets out the framework for collateral assets located outside the Union, under the following conditions:

- Article 7(1): Subject to Article 7(2), Member States may exercise the national discretion to allow credit institutions issuing covered bonds to include assets in the cover pool that are secured by collateral assets located outside the EU. This provision qualifies as a national discretion and thus is not required for Member States to be implemented.
- Article 7(2): Where Member States allow for the inclusion of assets as referred to in Article 7(1), they shall ensure investor protection by requiring issuing institutions to verify that those assets meet all the requirements set out in Article 6 of the CBD. Also, the assets shall offer a level of security similar to that of those located in the EU and shall ensure that their realisation is legally enforceable in the same way of those located in the EU.

2.4.2 GEOGRAPHICAL LOCATION FRAMEWORKS IN THE EU

There is high heterogeneity on the eligibility of assets located outside the Union for collateral purposes across EU jurisdictions. National implementations of this discretion vary both in terms of geographical scope and the method used to ensure legal enforceability of third country-assets. A thorough overview of the results can be found in Figure 11.

Across the EU, national approaches to the geographical location of covered bond collateral fall into two broad categories: those that confine eligibility to EU/EEA assets and those that permit a wider scope, subject to safeguards.

Among those who allow third-country assets, many have limitations in place on specific jurisdictions. Some Member States have a closed list of eligible countries, while others allow in principle any third country assets subject to additional restrictions that serve as safeguards to the investor. (62) (63)

In any case, and apart from national decisions upon restrictions, Article 7(2) of the CBD requires explicitly Member States to ensure that the realisation of third country collateral assets is legally enforceable in a way, which is equivalent to assets located in the EU. As to the implementation of the requirement, Member States are granted flexibility.

In some countries, it is left up to the issuer to ensure that legal enforceability is equivalent, which clearly requires specifying it contractually. In other countries, it is instead a direct legal requirement, but in practice it may also be solved contractually. Where a Member State has a closed list of third country jurisdictions allowed, a sufficient level of enforceability is usually tested beforehand. Some countries require a legal opinion on the enforceability. (64)

Regardless of the provisions adopted, it is clear that Member States largely leave it to issuers to ensure equivalent legal enforceability of third country assets.

(62) Some countries (for instance Hungary) apply restrictions even to non-domestic EU/EEA-located assets, allowing a maximum of 15% over the total cover pool.

(63) For instance, Denmark requires the third country to comply with all the legal provisions set in Danish legislation, while Germany requires to respect certain fundamental principles of secured lenders' rights for ships and aircraft liens. France only accepts jurisdictions with the best credit quality step, while Bulgaria only those with which it has agreements for the protection of investments, for the avoidance of double taxation, and if the issuing bank or a bank belonging to the same group has a branch in the country.

(64) For instance, in Bulgaria the opinion must state that arrangements for obtaining satisfaction are equivalent to those in the EU/EEA, while in Greece the credit institution must submit a legal confirmation that the investors claim enjoy a level of security similar to that granted by Greek law.

Figure 11: Overview of the different national legislation frameworks on geographical location

Member State	Which geographical location of assets is allowed?	How is legal enforceability of assets located outside the Union assessed?
Austria	More than EU/EEA ([65])	-
Belgium	Only EU/EEA	-
Bulgaria	More than EU/EEA ([66])	Legal opinion
Cyprus	More than EU/EEA ([67])	-
Czechia	Only EU	-
Denmark	More than EU/EEA ([68])	Contractually ([69])
Estonia	Only EU/EEA	-
Finland	Only EU/EEA	-
France	More than EU/EEA ([70])	Legally ([71])
Germany	More than EU/EEA ([72])	Legally ([73])
Greece	More than EU/EEA ([74])	Legal opinion/Supervision ([75])
Hungary	Only EU/EEA	-
Ireland	More than EU/EEA ([76])	Legally ([77])

([65]) Includes CH and the UK.

([66]) Allowed for assets which are located or recorded in a register in a third country wherewith the Republic of Bulgaria has agreements for the protection of investment and for the avoidance of double taxation in force and wherein the issuing bank or a bank belonging to the same group is established. No utilisation in practice.

([67]) No utilisation in practice. The only cover bond issued is collateralised by assets located only in Cyprus.

([68]) Collateral assets outside the EU/EEA must also adhere to the Danish Mortgage Bonds Act. In practice, it is very difficult for collateral assets outside the EU to adhere to requirements in this Act as it is tailored for the Danish system. Upon application, the DFSA can waive some of the requirements of the Act. No utilisation of the waiver as of now.

([69]) It is legally required that the institute ensures that the loan constitutes a legally valid payment claim that, in accordance with its wording, can be enforced if the debtor defaults on the claim.

([70]) If the third country has the best credit quality step established by an external credit assessment body recognised by the ACPR.

([71]) Ensured by way of requiring the third country to have the best CQS.

([72]) Eligible jurisdictions outside the EU/EEA depends on the type of primary asset. For mortgages: AU, CA, CH, JP, NZ, SG, UK, US. For public sector assets: CA, CH, JP, US, UK. For ship and aircraft liens: no restriction as long as certain fundamental principles of secured lenders' rights are respected within the jurisdiction in question.

([73]) Ensured by way of allowing only a closed list of tested jurisdictions. For ships and aircraft liens, the legal system must provide for the possibility of encumbrances of collateral assets to be registered in a public register, comparability of secured creditors' rights over encumbered collateral assets, and for the legal system in question not to be known for treating foreign creditors adversely compared to domestic ones.

([74]) Only in the case of loans secured by ship liens.

([75]) The credit institution must submit a legal confirmation to the Bank of Greece that the collateral asset is a ship lien, that the claim to the collateral is in a public registry, and that the investors claim enjoys a level of security like that of collateral assets located in Greece under Greek law.

([76]) Allowed for AU, CA, CH, JP, NZ, US.

([77]) Collateral in third countries must adhere to the same ruleset as collateral within EU/EEA, including on enforceability.

Member State	Which geographical location of assets is allowed?	How is legal enforceability of assets located outside the Union assessed?
Italy	More than EU/EEA ([78])	Contractually ([79])
Lithuania	More than EU/EEA	Contractually ([77])
Luxembourg	More than EU/EEA	Legally ([80])
Netherlands	Only EU/EEA	-
Poland	Only EU/EEA	-
Portugal	Only EU/EEA	-
Romania	Only EU/EEA	-
Slovenia	Only EU/EEA	-
Slovakia	Only EU/EEA	-
Spain	More than EU/EEA	Contractually ([77])
Sweden	Only EU/EEA	-

2.4.3 POLICY ASSESSMENT AND CONCLUSIONS

The EBA acknowledges that Member States have adopted two main approaches to the geographical scope of covered-bond collateral. Approximately half limit eligible assets to those located within the EU or EEA, requiring no additional enforceability measures. The others permit assets from outside the EU, subject to one of three enforceability mechanisms: statutory equivalence tests, external legal opinions, or contractual provisions in bond documentation. These frameworks aim to ensure that non-EU assets can be realised with the same legal effectiveness as domestic collateral, while allowing for varying degrees of geographic flexibility. Having considered the high level or protection present in those Member States that allow such assets, the EBA has no policy recommendation in relation to this topic.

2.5 Intragroup pooled covered bond structures and joint funding

2.5.1 INTRODUCTION AND LEGAL REFERENCE

Article 8 and 9 of the CBD allow Member States to implement flexible structures for issuers– intragroup and joint – to support broader access to the covered bond market while maintaining investor protection and supervisory oversight.

Article 8 of the CBD allows Member States to lay down rules regarding the use of intragroup pooled covered bond structures, under which, covered bonds issued by a credit institution that belongs to a group are used as cover assets for external issuances of covered bonds by another credit institution that belongs to the same group within the same Member State (externally issued

([78]) Only CH.

([79]) Must be ensured by the issuer.

([80]) The charges on moveable property must be certified by another form of certification or entered in a public register located within another State.

covered bonds). These rules are subject to a series of requirements aimed at ensuring that the structure of the product is clear enough and that the issuance operations are within the perimeter of the institution, in addition to ensuring the quality of the assets. The main effect of this structure is the exemption from the CRR-limits on credit institution exposure by way of Article 129(1b) of the CRR.

Article 9 of the CBD allows eligible cover assets that were originated by certain third parties and have been purchased by a credit institution issuing covered bonds to be used as cover assets for the issuance of covered bonds. Article 9(2) of the CBD also gives Member States the option to allow transfers by way of financial collateral arrangements pursuant to Directive 2002/47/EC, ([81]) while Article 9(3) of the CBD allows assets that were originated by an undertaking that is not a credit institution as cover assets. Where Member States exercise the option in Article 9(3), they shall require that the credit institution issuing the covered bonds either assesses the credit-granting standards of the undertaking, which originated the cover assets, or itself performs a thorough assessment of the borrower's creditworthiness.

2.5.2 INTRAGROUP COVERED BOND STRUCTURES AND JOINT FUNDING FRAMEWORKS IN THE EU

In total, ten countries reported that they have implemented the discretion set forth in Article 8 of the CBD. However, most of them specify that there has been no utilisation so far. ([82]) In contrast, fourteen countries have adopted the discretion set forth in Article 9(2) of the CBD, whilst eleven countries have adopted the discretion set forth in Article 9(3) of the CBD (allowing assets that were originated by non-credit institutions to be used as cover assets). A thorough overview of the results can be found in Figure 12.

Most Member States that have implemented the discretion provided for in Article 8 of the CBD of using intragroup pooled structures in general have also chosen to implement the discretion provided in the last Paragraph of Article 8 to allow for CQS2 covered bonds in these structures. However, there is not much appetite for issuers to exercise this discretion in most countries.

The purpose of Article 9 of the CBD in allowing joint funding is to allow the establishment of covered bond programmes without high upfront costs and to enable the issuance of covered bonds by smaller credit institutions, facilitating the issuing of covered bonds also in those jurisdictions where there is currently no well-developed covered bond market (as per Preamble 21 of the CBD).

There are additional requirements outside the ones mentioned in Article 9(3) of the CBD that cause significant heterogeneity (i.e. the assessment of the credit-granting standards of the undertaking which originated the cover assets, or performing itself a thorough assessment of the borrower's creditworthiness).

The Member States that do impose additional requirements do so differently. Some implement the national discretion in a stricter fashion. For example, by only allowing these cover assets if the entity other than a credit institution is included in the prudential scope of consolidation of the issuer. Some countries set up additional safeguards by allowing only the transfer of cover assets with the approval of the relevant Ministry or Central Bank, or by requiring adequate collateralisation of the cover pool.

([81]) Directive 2002/47/EC of the European Parliament and of the Council of 6 June 2002 on financial collateral arrangements (OJ L 168, 27.6.2002, p. 43, ELI: http://data.europa.eu/eli/dir/2002/47/oj).

([82]) The only exception being Denmark. In the Danish framework, one mortgage credit institution (Institution A) grants a mortgage loan, which is funded by the same institution issuing a framework bond that is purchased by another institution within the same Group (Institution B). Institution B funds this purchase by issuing covered bonds itself. there is match-funding between Institution A's mortgage loans and the bonds issued by Institution B in the market, which thus indirectly fund Institution A's lending. Denmark requires a specific permission granted by the national FSA to allow institutions to use this type of structure.

Figure 12: Overview of the different national legislation frameworks on intragroup covered bond structures and joint funding

Member State	Intragroup pooled covered bonds structures allowed (Article 8 of the CBD)	CQS 2 allowed for Article 8 of the CBD	Transfer by financial collateral arrangements allowed (Article 9(2) of the CBD)	Non-credit institution assets allowed (Article 9(3) of the CBD)	Specific requirements for non-credit institution assets (83)
Austria	Yes (84)	Yes	Yes	Yes (85)	Yes (85)
Belgium	No	-	No	Yes (84)	Yes (86)
Bulgaria	Yes (84)	Yes	Yes (84)	No	-
Cyprus	Yes (84)	Yes	Yes (84)	Yes (84)	No
Czechia	No	-	Yes	No	-
Denmark	Yes	Yes	No	No	-
Estonia	No	-	No	No	-
Finland	No	-	Yes (87)	Yes (84)	No
France	No	-	Yes (88)	No	-
Germany	No	-	No	Yes (89)	Yes (90)

(83) Other than those already mentioned in Article 9(3) of the CBD.

(84) No utilisation in practice.

(85) Limited to certain claims.

(86) The non-credit institution of which the assets are originated must be included in the prudential scope of consolidation of the issuer.

(87) This is used by some entities conducting their business using an intermediary loan model. An intermediary loan may only be granted to a credit institution belonging to the same consolidation group or amalgamation of deposit banks as the issuer.

(88) Most issuers in France utilise this option.

(89) No quantitative data on utilisation, but it is assumed that mortgage portfolios purchased from insurance undertakings as well as claims on public sector bodies purchased free of warranty from public-private-partnership contractors are used as cover assets in a non-negligible manner.

(90) Third-party originated cover assets may only be registered in the issuers cover register when the issuer confirms the credit quality of the borrowers or, in case of the third party being a credit institution, confirms asset origination in line with all requirements prudentially relevant for banking business.

Member State	Intragroup pooled covered bonds structures allowed (Article 8 of the CBD)	CQS 2 allowed for Article 8 of the CBD	Transfer by financial collateral arrangements allowed (Article 9(2) of the CBD)	Non-credit institution assets allowed (Article 9(3) of the CBD)	Specific requirements for non-credit institution assets ([83])
Greece	Yes ([84])	Yes	Yes ([84])	Yes ([84]) ([91])	No
Hungary	No	-	No	No	-
Ireland	No	-	Yes ([84])	Yes	Yes ([92])
Italy	No	-	No	Yes ([84])	No
Lithuania	No	-	No	No	-
Luxembourg	Yes ([93])	Yes	Yes	Yes	No
Netherlands	No	-	Yes	No	-
Poland	No	-	No	No	-
Portugal	Yes ([84])	Yes	No	No	-
Romania	Yes ([84])	Yes	No	No	-
Slovenia	Yes ([84])	Yes	Yes ([84])	No	-
Slovakia	No	-	Yes ([84])	Yes ([84])	No
Spain	Yes ([84])	Yes	Yes	Yes	Yes ([94])
Sweden	No	-	Yes	Yes	No

([91]) Only cover assets that were initially originated by a credit institution, have been transferred to an EU-based entity, which is not a credit institution, and are subsequently transferred from it to a credit institution with its registered seat in Greece, may be used as cover assets.

([92]) Transfer of cover assets only allowed with the approval of the Minister of Finance if the credit institution is not associated, and the Central Bank of Ireland if the credit institution is associated.

([93]) Utilisation not specified.

([94]) Allowed only if the ownership of the asset has been transferred to the covered bonds issuer or if they are adequately collateralised.

2.5.3 POLICY ASSESSMENT

Regardless of the specifics of the provisions, which in the opinion of the EBA offer *per se* sufficient safeguards, there is the potential for an interpretation issue in the relationship between Article 9(2) and 9(3) of the CBD: Article 9(2) allows transfers by way of financial collateral arrangement pursuant to Directive 2002/47/EC (as opposed to transfer by purchase). This Directive applies to a wider range of institutions than just credit institutions (for example, investment firms and insurance companies).

In case a Member State has implemented both discretions, it may be possible – in theory – to use as cover assets those assets that were originated by a non-credit institution and are transferred by way of financial collateral arrangements.

However, it is unclear whether this possibility was intentional in the CBD. There is no specific linkage mentioned between the two provisions in either subparagraph, although they both mention that they must be applied without prejudice to the requirement set forth in the second Subparagraph of Article 9(1) of the CBD.

2.5.4 CONCLUSIONS AND POLICY RECOMMENDATIONS

In view of the fact that provisions set forth in Articles 8 and 9 of the CBD are important options to allow flexible issuance structures, in the spirit of the principle-based approach of the CBD, the EBA has no suggestions regarding additional safeguards. However, the EBA recommends clarifying the legal interpretation of the interaction between Article 9(2) and Article 9(3) of the CBD.

Recommendation 3. *On the hierarchy of the provisions regulating joint funding.*

Having acknowledged an ambiguity in the provisions set forth in Article 9 of the CBD, the EBA recommends to the COM to clarify the hierarchy between the two discretions allowed by Article 9(2) and 9(3) of the CBD (i.e. whether the two can be used in tandem, therefore allowing to use as cover assets those assets that were originated by a non-credit institution and at the same time are transferred by way of financial collateral arrangements).

3. DERIVATIVE CONTRACTS IN THE COVER POOL

KEY TAKEAWAYS OF THIS CHAPTER

DERIVATIVE CONTRACTS IN THE COVER POOL (ARTICLE 11 OF THE CBD)

Derivatives play an important role in the cover pool in that they can hedge against a number of risks (e.g. interest rate, exchange rate) that can ultimately undermine the value of the cover assets.

As long as the issuer is solvent, the hedging essentially benefits the issuer, on whom covered bond investors rely for payments due on the covered bonds. Only upon issuer insolvency, the hedging immediately benefits the covered bond investors in that the orderly liquidation of the covered bond estate is immunised against adverse market price changes. Consequently, the issuer insolvency must not constitute grounds for early termination by the counterparty. But even where this is contractually agreed, there may be instances that give concerns about the actual protection given by such terms.

This risk is more severe the higher the correlation between the possibility of a default of both the issuer and the counterparty. For example, where the said parties are within the same scope of prudential consolidation like – but not only – in SPV covered bond models.

To avoid the termination of the contract in case of issuer default, with the ultimate aim of continuing to guarantee investor protection against the risks that the derivative is supposed to cover, **the EBA recommends strengthening the protection of the derivative instrument by requiring counterparties to post cash or other high quality collateral**, and **to ensure full segregation of the collateral** for the benefit of the covered bond investor. In addition, **when the counterparty is either internal or part of the same scope of prudential consolidation**, **an alternative counterparty shall be appointed** and ready to step into the derivative contract **upon default or downgrade of the original counterparty/issuer**.

3.1 Introduction and legal reference

Article 11 of the CBD sets out minimum requirements for the use of derivative contracts as cover assets:

- The derivative contracts may be used for risk hedging purposes only and shall be adjusted in volume or removed in case of a reduction or cessation of the risk hedged.

- The derivative contracts shall be sufficiently documented.
- The derivative contracts shall be segregated in accordance with Article 12 of the CBD.
- The covered bond issuer's insolvency or resolution shall not constitute grounds for early termination of the derivative contract.
- The derivative contracts shall comply with the rules (to be) established by Member States on eligible derivative contracts' counterparties and necessary documentation.

3.2 EU law regulating derivative contracts in covered bonds

While it is common practise to micro or macro hedge interest rate risk and foreign exchange risk, derivative contracts in the context of the CBD are specific in that they are meant to immunise the covered bond estate against adverse impacts of market risk changes on the estate's ability to orderly wind-down in the event of issuer insolvency. Derivative contracts are specifically intended for the situation in which the first layer of recourse to the issuer (Article 4(1)(a) of the CBD) is no longer valid, a case where regular derivative transactions typically would have been terminated.

The use of derivatives by credit institutions is widely regulated under the European Market Infrastructure Regulation (EMIR) framework. For derivatives, concluded 'with a covered bond, a covered bond entity, or a cover pool', which is structurally understood to be synonymous with derivative contracts as regulated by Article 11 of the CBD, partial exemptions and specific modifications within that framework apply.

In accordance with Article 4(5) of the EMIR, ([95]) ([96]) derivatives concluded under derivative contracts within the meaning of Article 11 of the CBD need not be centrally cleared; in accordance with Article 11(15) of the EMIR, ([97]) margining requirements applicable for non-centrally cleared, non-intragroup derivatives of such kind are modified in that the only margining requirement applies to the counterparty of the covered bond, who is required to post variation margins only.

Both deviations essentially recognise the legal and operational limitations for covered bonds to individually post cover asset collateral. By applying these deviations only to covered bonds that comply with the core requirements of Article 129 of the CRR, for the EMIR framework it is sufficient that the counterparty is effectively adequately collateralised 'in kind' by way of holding a *pari passu* claim on the cover pool (and any obligations from the derivative contract constituting coverable obligations, Article 15(3)(1)(c) of the CBD) even in case of issuer insolvency. At the same time, existing EMIR rules all but prohibit the use of derivative contracts for covered bonds not qualifying under Article 129 of the CRR.

The EMIR framework, with which derivative contracts per Article 11 of the CBD are expected to comply, has thus some interaction with the covered bond framework: one needs to account – as a coverable obligation – not only for the immediate (latent) payment obligations of the (latent) covered bond estate (as would result from adverse market price change-induced revaluation of the derivatives concluded under a derivative contract), but also for the contingent obligations to return to the counterparty collateral received once the revaluation results in a reduced claim for collateralisation of the replacement cost exposure to that counterparty.

([95]) Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories (OJ L 201, 27.7.2012, p. 1, ELI: http://data.europa.eu/eli/reg/2012/648/oj).

([96]) In conjunction with Article 1(2) of Commission Delegated Regulation (EU) 2015/2205 of 6 August 2015 supplementing Regulation (EU) No 648/2012 of the European Parliament and of the Council with regard to regulatory technical standards on the clearing obligation (OJ L 314, 1.12.2015, p. 13, ELI: http://data.europa.eu/eli/reg_del/2015/2205/oj).

([97]) In conjunction with Article 30 of Commission Delegated Regulation (EU) 2016/2251 of 4 October 2016 supplementing Regulation (EU) No 648/2012 of the European Parliament and of the Council on OTC derivatives, central counterparties and trade repositories with regard to regulatory technical standards for risk-mitigation techniques for OTC derivative contracts not cleared by a central counterparty (OJ L 340, 15.12.2016, p. 9, ELI: http://data.europa.eu/eli/reg_del/2016/2251/oj).

Since the derivative contract is supposed to 'survive' the covered bond issuer's insolvency, the counterparty should address any claim for returning collateral previously posted and no longer required contractually also against the covered bond estate, implying that the covered bond estate needs to be able to meet such a claim not only by amount (Article 15 of the CBD), but also in terms of available liquidity (Article 16 of the CBD). Given that theoretically the market price changes prompting, the need to return collateral could occur at any time and theoretically at any amount, it is prudent to account for the full amount of collateral received from the counterparty as a next day outflow for liquidity coverage purposes, recognising that this is more conservative than the LCR's lookback approach. ([98])

As cash collateralisation is the market standard for variation margining, and given the fact that monies paid to the credit of the issuer's central bank operation account cannot be segregated to the covered bond estate, it is important to flag that cash received as collateral by the covered bond issuer for derivative contracts, will not automatically become part of the cover pool unless explicitly held in segregated third-party account.

3.3 Derivative contracts frameworks in the EU

According to the NCA questionnaire all Member States allow for – and in some cases even require – the inclusion of derivative contracts solely for hedging purposes in cover pools, while the actual utilisation of this possibility is scarce. A thorough overview of the results can be found in Figure 13.

Responses on other topics vary widely. Unsurprisingly, general counterparty eligibility clusters around minimum CQS 2 credit institutions (in some instances not restricted by country of establishment within the EU/EEA), with public and international authorities and other types of financial institutions as sporadic additions (some of which are ineligible for Article 129 of the CRR, e.g. insurance/reinsurance undertakings). Four Member States (Belgium, Cyprus, Germany and Greece) restrict derivative counterparty eligibility by degree of association with the covered bond issuer and excluded counterparties within the covered bond issuer's scope of prudential consolidation, whereas Italy, a country applying an SPV segregation model, explicitly allows as the hedging counterparty of the cover pool SPV to be the covered bond issuer itself.

([98]) The maximum of 30-day period outflow of received collateral over the previous two years.

Figure 13: Overview of the different national legislation frameworks on derivative contracts

Member State	Cover-eligibility / Relevance	Market risk impact captured in coverage (CR) or by stress testing (ST)	Hedging only: manner of assessment / application over time	Restrictions on derivative instrument type	Valuation	Eligible counterparties	Restrictions on counterparties' degree of association with issuer
Austria	Yes / -	No ([99])	- / Constantly	No	-	Federal government, provincial government, credit institution	-
Belgium	Yes / -	ST	- / Constantly	No	Close-out amount ([100])	Min. CQS 2 OECD credit institutions	No group members of the covered bond issuer
Bulgaria	Yes / -	ST	- / -	No	Market value ([101])	-	-
Cyprus	Yes / -	CR ([102])	- / -	No	-	Min. CQS 1 credit institutions, investments firms, insurance firms, central counterparties	No group members of the covered bond issuer
Czechia	Yes / -	No	- / -	No	Accounting value ([103])	-	-
Denmark	Yes / -	CR ([104])	Qualitatively / - ([105])	No	Market value ([106])	Min. CQS 2 credit institutions	-
Estonia	Yes / -	Yes	- / Constantly	No	Close-out amount	-	-

([99]) General requirement of adequate risk management of covered bond business.

([100]) For nominal coverage principle; issuer internal ALM modelling value for amortisation test.

([101]) Fair value (to be used also for nominal coverage purposes).

([102]) NPV coverage stressed for FX risk.

([103]) IFRS.

([104]) For 'match funded' programmes, fair valuation (assumed to be comparable to NPV) of coverable obligations and cover assets would reflect impact of spot FX rates and yield curves on coverage; 'balance principle', i.e. market risk limits applicable to covered bond programmes requiring additional over-collateralisation for limit excess amounts.

([105]) As the response mentions ongoing supervision, issuers may have to assess ongoing cover eligibility of derivative contracts under the hedging only paradigm constantly as well.

([106]) Fair value.

Member State	Cover-eligibility / Relevance	Market risk impact captured in coverage (CR) or by stress testing (ST)	Hedging only: manner of assessment / application over time	Restrictions on derivative instrument type	Valuation	Eligible counterparties	Restrictions on counterparties' degree of association with issuer
Finland	Yes / -	ST	- / Constantly	No	Market value (104)	Derivative contracts and associated counterparty credit risk shall meet the requirements of Article 129 of the CRR	-
France	Yes / Marginal	No (107)	- / -	No	-	-	-
Germany	Yes / 2 programmes	CR	Quantitatively (108) / Constantly (109)	Fixed instruments (e.g. swaps) only	Close-out amount (110)	Suitable min. CQS 2 credit institution (EU/EEA plus CA, CH, JP, UK, US), Bund, Federal State; CQS 3 credit institution subject to CA approval	No group members of the covered bond issuer
Greece	Yes / -	CR	- / -	No	Market value (111)	Min. CQS 2 credit institutions (no covered bond issuers), 0% risk-weighted public and international authorities	No group members of the covered bond issuer
Hungary	Yes (112) / 1 programme (113)	CR (114)	Qualitatively / Constantly (115)	No	Market value (116)	No restriction	-
Ireland	Yes / -	No (117)	- / - (103)	No	Prudent market value	Credit institution as per Article 129(1)(c) of the CRR	-

(107) Disclosure requirement only.

(108) Applicable GAAP hedge accounting treatment or other quantitative method.

(109) Permissible by way of concluding counter-hedges off-setting any excess derivative position with the same counterparty under the same derivative contract (master agreement).

(110) For nominal coverage (netting set, i.e. master agreement including received collateral), market value of single derivatives for present-value coverage, and cash-flow of single derivatives for liquidity coverage.

(111) Present value.

(112) Derivative hedging obligation for FX; effective derivative hedging obligation for material FX or IR risk.

(113) See also the EBA Opinion on the Hungarian Waiver under Article 129(1a)(c) of the CRR (Eba/Op/2024/08).

(114) Quarterly stress testing with requirement to top-up coverage for any resultant shortfalls.

(115) Requirement to close derivatives if hedged risk position expires, ongoing supervision.

(116) Present-value, net of received margining.

(117) Stress test limit at issuer level (akin to IRRBB outlier test), same currency requirement on coverable obligations and cover assets, Interest Coverage Test (12-month horizon), which is understood not to capture the impact of changes in market interest rates, in advance to their realisation.

Member State	Cover-eligibility / Relevance	Market risk impact captured in coverage (CR) or by stress testing (ST)	Hedging only: manner of assessment / application over time	Restrictions on derivative instrument type	Valuation	Eligible counterparties	Restrictions on counterparties' degree of association with issuer
Italy	Yes / 2 programmes	No	Qualitatively / Constantly	No	Value zero ([118])	Min. CQS 3 credit institutions	Issuer allowed
Lithuania	Yes / -	ST	Qualitatively / Constantly	No	- ([119])	Min. CQS 2 credit institutions, investment companies, insurance and/or reinsurance companies, other financial institutions, central counterparties and public institutions (central governments of MS and other public sector entities, the ECB, the IMF, the EIB, the BIS and multilateral development banks)	-
Luxembourg	Yes / -	No ([97])	- / -	-	-	-	-
Netherlands	Yes / Declining ([120])	No	- / Constantly	No	Nominal value	Financial institutions subject to supervision	-
Poland	Yes / 2 programmes	ST	- / Constantly	No	Market value	Min. CQS 2 domestic banks, credit institutions, brokerage houses or foreign investment firms	-
Portugal	Yes / -	No	- ([121]) / -	No	Market value	EU regulated market / MTF, recognised market full members OECD, EEA credit institutions as per Article 129 (1) (c) of the CRR	-
Romania	Yes / -	CR ([122])	Quantitatively ([123]) / Constantly	No	Market value ([124])	CCP, CQS 1 to 3 credit institutions	-

([118]) For nominal coverage. Replacement cost for present-value coverage.

([119]) 'Nominal principle', 'stress testing'.

([120]) Trend to replace derivatives by interest reserve requirements, minimum mortgage interest rate requirements and/or pledging of additional collateral.

([121]) Hedge accounting treatment under IFRS 9 for all listed companies is required.

([122]) 'Top-up' requirement under 'periodic' stress testing.

([123]) Also, designation as hedging purpose only required.

([124]) For coverage regime. Zero value for coverage ratio, market value for over-collateralisation indicator.

Member State	Cover-eligibility / Relevance	Market risk impact captured in coverage (CR) or by stress testing (ST)	Hedging only: manner of assessment / application over time	Restrictions on derivative instrument type	Valuation	Eligible counterparties	Restrictions on counterparties' degree of association with issuer
Slovenia	Yes / -	CR ([125])	- / Constantly	No	Market value ([126])	Credit institutions as per Article 129(1)(c) of the CRR, other financial institutions subject to supervision: investment firms, financial institutions, insurance companies, CIUs, investment management companies, central government of Slovenia and other public sector entities of EU responsible for management of public debt and entitled to keep accounts for their parties; central banks of EU MB, the ECB, the IMF, the EIB, the BIS and multilateral development banks; clearing houses, central counterparties and settlement agents	-
Slovakia	Yes ([127]) / -	CR	- / - ([103])	No	Market value ([128])	No restriction	-
Spain	Yes / -	No	Quantitatively ([129]) / Constantly	No	Accounting value ([130])	Credit institutions as per Article 129(1)(c) of the CRR	-
Sweden	Yes / -	CR, ST	Quantitatively / Constantly	No	Market value ([131])	CQS 1 and 2 credit institutions, CQS 3 credit institutions subject to CA approval	No

([125]) At least monthly stress testing for IR and FX risk.

([126]) Fair value where there is no active market.

([127]) Derivative hedging obligation for net FX and IR positions of the covered bond estate.

([128]) Fair value, only for derivatives hedging FX risk or hedging IR risks of substitution assets.

([129]) IFRS hedge accounting treatment plus designation as hedging only.

([130]) IFRS hedge accounting.

([131]) Nominal and market value for whole cover pool, including derivatives.

3.4 Feedback for the industry

The questionnaire to the industry touched upon the issue of derivative contracts separately for issuing banks, investors/analysts, and rating agencies:

- the use of derivatives by issuers for micro-hedging only or also for macro-hedging;
- the view of investors and analysts on derivative contracts in the cover pool;
- the specific requirements (if any) that the rating agencies apply with respect to derivative contracts in the cover pool.

A majority of twelve individual issuers confirmed the finding of scarce utilisation of the instrument collected from the questionnaire to the NCA, reporting that they did not use derivative contracts in their covered bond programmes at all. Out of the seven issuers confirming the use of derivative contracts, three respondents use micro-hedging only, three use both micro and macro, and one uses macro-hedging only.

While derivative contracts are generally viewed by analysts to be of minor impact, investors appear to be more ambivalent, insomuch that out of the five responses received, two see derivative contracts in the cover pool positively, two see them negatively, and one neutrally.

As to the credit rating agencies, the approach to derivative contracts in the context of covered bond ratings takes into account the modelling of discontinuation of the derivative contract upon issuer default, due to legal challenges or payment defaults by the covered bond estate.

Some market participants warn that hedging against risks using derivatives is not always straightforward. They state various reasons (e.g. lack of suitable counterparties, as is the case in Italy due to excessive market concentration), which makes the recourse to other forms of protection to maintain a high rating inevitable (for instance, via increasing over-collateralisation, which bears the unintended consequence of a higher burden in terms of asset encumbrance).

3.5 Policy assessment

The EBA analysed thoroughly the issue arising from a high risk of correlated default of the covered bond issuer and the derivative contract's counterparty. While the risk follows trivially for cases where the covered bond issuer and the derivative contract provider share a common identity (as in Italy), this is also of concern with respect to internal group hedges in other covered bond models. It follows that in the event of a covered bond issuer default other members of the group, including the derivative contract's counterparty, may be failing as well, rendering the protection of covered bondholders, as intended by requiring the derivative contract to not be terminated upon issuer insolvency, essentially void.

3.6 Conclusions and policy recommendations

The EBA deems it appropriate to introduce additional safeguards that would increase the ability of the covered bond estate subsequent to issuer default to effectively replicate the hedge that is likely to have terminated. Such safeguards should apply not only for cases of identity of hedge provider and covered bond issuers, but equally for counterparties within the perimeter of the covered bond issuer's scope of prudential consolidation.

Recommendation 4. *On the nature of collateral in derivative contracts.*

For all derivative contracts, the counterparty to the covered bond estate (the counterparty to the segregation SPV in the case of covered bond models based on SPVs, or generally any counterparty within the perimeter of the issuer's scope of prudential consolidation) shall be required to post collateral either in cash or securities issued by CQS 1 central governments.

Recommendation 5. *On the segregation of collateral in derivative contracts.*

The EBA recommends for all derivative contracts received collateral to be segregated to the covered bond estate in accordance with Article 12 of the CBD. Special consideration shall be given to the segregation of cash collateral received (as mere registration to the cover pool of the amount received may not constitute sufficient segregation unless held in a registered segregated account with a third-party neither associated with the covered bond issuer nor the derivative contract's counterparty). Where received cash collateral is invested in other types of cover-eligible assets, these shall be of extremely high-quality and liquidity in order to allow for the covered bond estate not to default on any repayment obligation with regard to the received cash collateral.

Recommendation 6. *On internal hedges.*

For 'internal hedges' (i.e. derivative contracts concluded between a cover pool segregation SPV and the issuer of the corresponding covered bonds, as well as between a covered bond issuer and a counterparty that is part of the same scope of prudential consolidation as the covered bond issuer), the EBA recommends that either of the following conditions shall be in place:

- *The presence of a committed substitute counterparty that would step into the internal hedge derivative contract terminated at the latest upon default of the counterparty to the covered bond estate/segregation SPV; any payment required by the substitute counterparty as initial payment upon stepping into the terminated internal hedge contract shall be determinable in advance and be required to be held as additional over-collateralisation, easily available to effect any such initial payment.*
- *The requirement for the internal hedge to be substituted by a hedge with an external eligible counterparty, replicating the material conditions of the internal hedge, once the credit quality step attributable to the internal hedge's counterparty to the covered bond estate/segregation SPV falls below CQS 2, or CQS 3 where the waiver in accordance with Article 129(1a)(c) of the CRR is in effect. Any cost of the substitution shall be made payable upfront and be borne by the counterparty to the internal hedge to be substituted.*

4. COVER POOL MONITOR

KEY TAKEAWAYS OF THIS CHAPTER

COVER POOL MONITOR (ARTICLE 13 OF THE CBD)

The CBD gives the possibility to the issuer to appoint a cover pool monitor (i.e. a monitoring body ensuring that the cover pool remains aligned with most of the provisions set by the Directive in terms of eligibility and performance). The appointment of a CPM acts an additional guarantee of ongoing control of the quality and safety of the product to the investor. The overarching principle guiding the appointment of a CPM shall be to ensure the independence and separateness of the monitoring functions from the issuer's own interest.

At the same time, the CBD allows for the appointment of an internal cover pool monitor (i.e. a CPM composed by employees or branches of the institution tasked with this function), provided there are limitations in place to avoid conflicts of interest. The EBA acknowledges that most Member States do not exercise this discretion and that, even where it is allowed, the appointment of internal CPMs has almost never occurred. **The EBA** is of the opinion that such discretion can pose threats to the independence and separateness of the function of the CPM and therefore **recommends eliminating the possibility of using an internal CPM, with the possibility of a transition period with enhanced safeguards** (e.g. approval of the NCA for any CPM action, etc.).

4.1 Introduction and legal reference

In accordance with the provisions set forth in Article 13(1) of the CBD, Member States have the option to require an ongoing monitoring of the performance and the eligibility requirements of the cover pool to be performed by a 'cover pool monitor' (CPM) that respects certain characteristics listed in the said Article, the most important of which is the independence and separateness from the issuing institution (Article 13(3) of the CBD). In such a situation, the monitor is said to be external. However, the CBD permits to deviate from this general rule by appointing a monitor that is internal to the institution's legal perimeter, provided some requirements are met.

Where Member States exercise the option provided for in Article 13(1) of the CBD, they shall lay down rules on at least the following aspects: (a) the appointment and dismissal of the cover pool monitor; (b) any eligibility criteria for the cover pool monitor; (c) the role and duties of the cover pool monitor, including in the case of the insolvency or resolution of the credit institution issuing the covered bonds; (d) the obligation to report to the competent authorities designated pursuant to Article 18(2) of the CBD; (e) the right of access to information necessary for the performance of the cover pool monitor's duties.

A number of Member States require additionally that a CPM performs specific tasks regarding the quality of eligible assets and ensures compliance with national coverage requirements, in accordance with their transposition of the requirements set out in Article 6 to 12 and Article 14 to 17 of the CBD, respectively. In any case, the presence of a CPM does not waive the responsibilities of the NCA on covered bond public supervision in particular on the compliance with the requirements of the national law transposing the CBD.

4.2 The cover pool monitor frameworks in the EU

The questionnaire collected information from NCAs on whether they exercised the option to appoint a CPM. If NCAs do exercise this option to appoint a CPM, they were questioned on the rules for its appointment and dismissal, the eligibility criteria, the role and duties of the CPM (including in the case of the insolvency or resolution of the issuing institution), the CPM's obligation to report to the NCA and the right of access to information necessary for the performance of the CPM's duties. A thorough overview of the results can be found in Figure 14.

Results show that an internal CPM is not permitted by a majority of countries, and out of the few who do, only three of them are used *de facto*.

In the majority of countries, the CPM is appointed by the issuer with the approval of the NCA. When appointed by the issuer alone, a notification to the NCA is required in most countries. Direct appointment by the NCA is mandatory only in two countries.

The dismissal procedure mainly depends on the legal provisions regulating the appointment or authorisation process of the CPM. In special circumstances, the NCA can have the power to dismiss the CPM. For example, when the covered bond is placed under separate administration, for inaction of the issuing bank in case of breach of the legal conditions. Involuntary dismissals (before the contact end date) are usually not explicitly regulated. In general, CPMs are dismissed because: a condition for the appointment is no longer fulfilled; there is a major breach of duty; the special administrator is appointed; the covered bond estate is declared bankrupt; the CPM resigns at own request; the term of appointment has finished; the CPM is sanctioned in accordance with national covered bond regulation.

In many cases, there is no legal or contractual term for the appointment of the external CPM. Where a term is regulated by law, the minimum usually ranges from one to four years and the maximum between five to ten years. Only one country has established a minimum and a maximum term. There is no rotation policy of the external CPM in the majority of countries.

In the majority of countries, the CPM needs to be a statutory external auditor for credit institutions, and it cannot be the external auditor of the issuing credit institution (to guarantee independence). In this case, the fit and proper test and independence are presumed to be guaranteed by the general rules applicable to statutory auditors. In other countries, the external CPM could be an attorney, a law company or an auditor or auditing company, a natural person or a commercial firm. In this case, it is required (via a fit and proper test) that the external CPM fulfils certain requirements, both professional and reputational.

In case auditors are not statutory, independence is guaranteed by requiring that: the subject has no financial interests; it is not in any kind of contractual relationship with the issuing bank or with any parties related; it has been an administrator of the issuing bank for no more than three years; it is not an employee of the issuing bank directly involved in the credit decision process or a member of the auditor team of the audit companies of the issuing bank or its group; it has not been charged for failing to comply with the requirements of banking regulation, including the CBD; it has not direct or indirect ownership interests in the issuer (and in undertakings forming part of its group); it has not been legal advisor of the issuing group or providing any other services; and it has generally speaking no conflict of interest.

In a majority of countries, the CPM mainly performs the ongoing monitoring of the cover pool as per the requirements set out in Articles 6 to 12 and

Articles 14 to 17 of the CBD, but is sometimes assigned additional tasks. ([132])

Depending on the national regulation on cover asset segregation, the CPM may play a role in the registration process. It may be particularly involved in the approval of any modifications incurred in the pool, and in the certification of its composition. The removal from the cover pool (de-registration of cover assets) may also require the approval of the CPM.

In some countries, the CPM has the right to inspect or have access to the books, documents and data of the credit institution to the extent that they relate to covered bonds as well as to the cover assets entered in the cover register. In some cases, the credit institution is obliged to notify the CPM on an ongoing basis about the repayments of the principal on the cover assets, as well as other significant changes for the creditors of covered bonds and for the counterparties of claims arising from derivative contracts related to these titles.

In most cases, there are no specific rules on the remuneration of the external CPM. In practice, the external CPM is remunerated by the credit institution appointing it in accordance with the contractual agreement reached. In some countries, the remuneration is set instead by the NCA and directly paid by the issuer.

([132]) For instance checks on: the results of the issuer's stress tests and the related action taken, the issuer's compliance with risk management and reporting procedures, the proper monitoring of market and operational risks by the issuer, the issuer's internal policies, the integrity of the information provided to authorities and investors, the fulfilment of Article 129 of the CRR requirements (for 'European Covered Bond Premium' bonds), the availability and registration of cover assets (subject to which a certificate is issued). In some countries, prior to issuing covered bonds, the CPM must submit a report to the NCA about the results of these checks.

Figure 14: Overview of the different national legislation frameworks on cover pool monitor

Member State	Internal monitor permitted	CPM appointment	Deputy CPM required	Contractual terms/ restrictions	Who has the power of dismissal	Supervisory power against CPM	Remuneration
Austria	Yes	Issuer (with notification to NCA)	No	Max 5y	Issuer	No	Contractual agreement
Belgium	No	Issuer (with approval of NCA)	No	No (133) (134)	Issuer (with approval of NCA)	Yes (135)	Contractual agreement
Bulgaria	No	Issuer (with approval of NCA)	No	No (136)	NCA, issuer (with approval of NCA)	Yes, including sanctioning	Contractual agreement
Cyprus	Yes (137)	Issuer (with approval of NCA)	No	No	NCA, issuer (with approval of NCA)	Yes (138)	Contractual agreement
Czechia	- (139)	-	-	-	-	-	-
Denmark	No	- (140)	No	-	-	-	-
Estonia	No	Issuer (with notification to NCA)	No	Min 1y (132)	Issuer	Yes (141)	Contractual agreement
Finland	- (142)	-	-	-	-	-	-

(133) For the full duration of the programme (or until a special administrator is appointed).

(134) Only statutory auditors different from the external auditor can be appointed.

(135) As external auditor.

(136) The appointment of the CPM may be on such terms and subject to such conditions as the Central Bank deems it necessary.

(137) Never appointed in practice.

(138) Dismissal.

(139) The Czech Act No. 190/2004 Coll. on Bonds (as amended) does not include provision for cover pool monitor (Article 13 of the CBD). However, the law does not prevent cover pool monitor from being introduced voluntarily, with terms decided by the issuer.

(140) No CPM (duties performed by accounting auditor).

(141) To issue precepts to issuer requiring the replacement of the CPM, with fines in case of a failure to submit information.

(142) The Finnish Act on Mortgage Credit Banks and Covered Bonds (151/2022) does not include provision for cover pool monitor (Article 13 of the CBD).

Member State	Internal monitor permitted	CPM appointment	Deputy CPM required	Contractual terms/ restrictions	Who has the power of dismissal	Supervisory power against CPM	Remuneration
France	No	Issuer (on a list established by the ACPR)	Yes (143)	Min 4y (132)	NCA, President of the Commercial Court upon request from the issuing institution	Yes (136)	Legislation (144)
Germany	No	NCA	Yes (145)	Max 5y (146)	NCA	Yes, including role in case of conflict	Supervisory practice (147)
Greece	No	Issuer	No	No	Issuer	No	Contractual agreement
Hungary	No	Issuer (with approval of NCA)	No	Max 5y	Issuer (with approval of NCA)	Other (148)	Contractual agreement
Ireland	No	Issuer (with approval of NCA)	No	No	Issuer, issuer (with approval of NCA)	No (149)	Contractual agreement
Italy	No	Issuer (with approval of NCA)	No	No (132)	Issuer, NCA	Yes, including sanctioning	Contractual agreement
Lithuania	Yes (135)	Issuer (with approval of NCA)	No	No (132)	Issuer, NCA	Yes (150)	Contractual agreement
Luxembourg	No	Issuer (with approval of NCA)	No	No (132) (151)	NCA	Yes, including sanctioning and role in case of conflict	Contractual agreement
Netherlands	Yes	Issuer	No	No	Issuer (with approval of NCA)	Yes, (152) including role in case of conflict (148)	Contractual agreement

(143) One deputy. The alternate CPM is called upon to replace the incumbent in the event of refusal, impediment, resignation or death.

(144) Regulation of statutory auditors.

(145) One CPM and one alternate have to be appointed at each Pfandbrief bank (i.e. for all of that issuer's covered bond programmes) before first issuance of a Pfandbrief. Additional alternates upon Pfandbrief banks' request.

(146) But not beyond the end of month of the 75th birthday of the person in question.

(147) Set by CA and directly paid by the issuer.

(148) NCA responsibility shall be governed by general rules of responsibility under civil law.

(149) But can direct a designated credit institution to terminate the appointment of the cover-assets monitor and to appoint another qualified person by written notice to the institution and cover-assets monitor concerned.

(150) It may make recommendations to the CPM regarding the information contained in the covered bond issuer's annual compliance report prepared by him. The supervisory authority has the right to oblige to replace the CPM.

(151) With rotation policy.

(152) If internal.

Member State	Internal monitor permitted	CPM appointment	Deputy CPM required	Contractual terms/ restrictions	Who has the power of dismissal	Supervisory power against CPM	Remuneration
Poland	No	Issuer (with approval of NCA)	Yes (153)	Max 6y (154)	NCA	Yes, (136) including role in case of conflict	Supervisory practice (155)
Portugal	Yes (135)	Issuer (with approval of NCA)	No	Max 10y (132) (149)	Issuer (156)	Yes	Other (157)
Romania	No	Issuer (with approval of NCA)	No	No	NCA	Yes	Contractual agreement
Slovenia	Yes (135)	Issuer (with approval of NCA) (158)	Yes (159)	No	NCA, issuer (with approval of NCA)	Yes, including sanctioning	Contractual agreement
Slovakia	Yes	Issuer (with approval of NCA)	Yes (160)	No	Issuer, issuer (with approval of NCA)	Yes, including sanctioning and role in case of conflict	Contractual agreement (161)
Spain	Yes (135)	Issuer (with approval of NCA)	No	Min 3y, max 10y (162)	Issuer (with approval of NCA)	Yes, including sanctioning	Contractual agreement
Sweden	No	NCA (163)	No	No	NCA (164)	Yes (136)	Contractual agreement

(153) A CPM and at least one CPM deputy. The number of deputies should be adjusted to the scale of a mortgage bank's activities.

(154) Rotation policy: a CPM may be appointed for another tenure, but only once.

(155) Set by CA and directly paid by the issuer. The remuneration is stated within a decision on the appointment of a CPM.

(156) With communication to the NCA.

(157) As statutory auditors, remuneration is primarily ruled by legislation, with additional supervisory practices ensuring adherence to ethical and independence standards. Contractual agreements between the auditor and the entity also play a role in determining the specific amount of the fees, but always within the framework of legal requirements.

(158) Prior permission by the Bank of Slovenia in consultation with the Securities market agency.

(159) Each CPM should have at least one deputy.

(160) One deputy.

(161) With NCA approval.

(162) Rotation policy: it may be contracted again once three years have elapsed since cessation.

(163) The NCA appoints an independent inspector to monitor the cover pool. The independent inspector produces a report for the NCA. The independent inspector has a similar role to a CPM. However, it is ultimately up to the NCA to assess if the institute fulfils regulatory requirements. The model ensures independence and separateness of the function.

(164) The NCA applies a rotation policy for the independent inspectors.

4.3 Policy assessment

The EBA identified as a major source of concern the issue of whether the appointment of an internal CPM – regardless of the specific requirements – is compatible with the definition of independence and, if so, whether the requirements in place constitute sufficient safeguards.

As it emerged from the results of the NCA questionnaire, at present eight countries allow internal CPM, but only three of them have appointed them in practice, and all with additional limitations. This hints to the fact that in most cases the CBD was translated into national law without the provision for the appointment of an internal CPM being previously exercised.

In addition, the EBA analysed closely the interpretation of the concept of independence and the separateness of the CPM from other entities that have ties with the issuer. Clearly, this criterion also applies to externally appointed bodies. In fact, it appeared that it is sometime current practice to appoint CPMs within the same firm that is already providing other services to the issuer (most commonly auditing), even though the two providers may be nominally part of different teams or branches of the same firm).

There are advantages and disadvantages in assigning the cover pool monitoring function to a separate entity. On the one hand, it would fully reflect a consistent interpretation of independence and separateness as per Article 13(3) of the CBD, and it would avoid any possible conflict of interest that may arise from the same firm having two or more mandates for the issuer. On the other hand, it may be difficult from a practical point of view to find different firms providing the two (or more) services, given the high market concentration in this sector.

When legislation allows qualified entities (mostly auditors) to perform the role of CPM, in addition to other services like auditing, the EBA is of the opinion that adequate measures to ensure independence and separateness to protect investors from issues arising from conflicts of interest between different functions should be in place.

Finally, the EBA analysed the characteristics of the CPM in terms of the type of body and required professional qualifications. As it emerged from the questionnaire, some countries specifically demand the monitor to be a legally qualified firm (usually with the same authorisation that is necessary for the auditing business), while some others allow natural persons who are deemed to be an expert in the field to be appointed.

Once again, a trade-off exists between the safeguards that a legally qualified firm could bring in terms of conflicts of interest, and the cost that switching from a single professional to such firms would imply, especially for small issuers.

4.4 Conclusions and policy recommendations

On the issue of an internal CPM, there is the risk that the possibility to deviate from Article 13(3) of the CBD by allowing an internal CPM is incompatible with a stricter interpretation of independence. For this reason, and in addition to the fact that the appointment of such a monitor is *de facto* unutilised in the countries that allow them, there is sufficient rationale for an elimination of this discretion from the CBD.

For what concerns the characteristics of the CPM, given the different CB models and the availability of qualified professionals on the market, the EBA does not deem it appropriate to suggest a unified framework in which only legally authorised professional firms are allowed to be appointed as a CPM.

Recommendation 7. *On the appointment of internal cover pool monitors.*

Having assessed the possible implications of the appointment of an internal cover pool monitor for the principles of independence and separateness of the monitoring function, the EBA recommends removing the possibility to exercise this discretion.

As an interim solution, NCAs are recommended to check the adequacy of the safeguards in place to ensure the independence and separateness of the functions (for instance, to ensure that monitors are in no case involved in the cover bond business and/or registration of cover assets, and that they are mandatorily approved by the supervisory authority).

5. TRANSPARENCY

KEY TAKEAWAYS OF THIS CHAPTER

TRANSPARENCY (ARTICLE 14 OF THE CBD)

A key feature of a high-quality financial instrument like the covered bond is the transparency of the required information disclosed to the investor. The CBD requires issuers to disclose at a relatively high frequency (at least quarterly) a wide range of information regarding the composition of the cover pool, the associated risks, the maturity structure of the underlying assets, the percentage of assets under default, etc.

At the same time, the framework is silent with respect to the modalities with which such information shall be disclosed, leaving high flexibility to the issuer. During the past years, most of the industry has converged to the adoption of the Harmonised Transparency Template (HTT) provided by the ECBC, as a market standard. Considering the role of this market initiative, **the EBA** is of the opinion that the principle-based approach of the CBD is fit for purpose, and it **recommends Member States to mention in the national regulation the preferred modality of disclosure**, as is already the case in some jurisdictions.

5.1 Introduction and legal reference

Article 14 of the CBD requires Member States to ensure that issuers provide sufficient product information for the investor to properly assess the risks and carry out their due diligence. To facilitate the transposition into the different national frameworks – which exhibit very little harmonisation – the CBD follows a principle-based approach rather than laying down detailed, rule-based legal provisions.

Article 14 of the CBD identifies the following list of minimum portfolio information to be included in the investor information: information on the value of the cover pool and outstanding covered bonds, details on the cover assets (geographical distribution, type of cover assets, their loan size and valuation method), details in relation to exposure to various risks (market risk, including interest rate risk and currency risk, credit and liquidity risk), the maturity structure of cover assets and covered bonds (including an overview on maturity extension triggers, if applicable), coverage levels (including statutory, contractual and voluntary over-collateralisation) and the share of defaulted loans in accordance with the prudential framework (as per Article 178 of the CRR), as well as any case where the loans are more than 90 days past due.

In accordance with Article 14 (2) and (3) of the CBD, the above-mentioned information should be provided at least on a quarterly basis and must be published on the website of the credit institution issuing covered bonds.

5.2 The transparency frameworks in the EU

The questionnaire gathered information on the transparency frameworks across different national legislations. A thorough overview of the results can be found in Figure 15.

Regarding the type of information provided to investors, there is a high level of heterogeneity. Most countries merely translated the provisions listed in Article 14 of the CBD, without specifying how the information should be concretely provided (for instance, on the exposure to market, credit and liquidity risk). There are only a few cases where some additional details are provided in the regulation, albeit limited to a few specific aspects. ([165])

A few Member States have established more detailed frameworks, which require (for instance), to disclose detailed information on the distribution of cover assets with respect to several dimensions (interest percentages, loan seasoning, type of property, level of prepayments, accounting classification of loans), separate requirements for different types of covered bonds (mortgage, ship/aircraft and public sector) and several prescriptions to allow assessing the exposure to credit, market, and liquidity risk. ([166])

Information on the level and type of information disclosed on substitution assets for coverage purposes also suffers from a lack of harmonisation. Nearly half of the Member States do not require issuing banks to disclose information on substitution assets, while others just mention in their regulation the need to disclose it, but without prescribing any further detail (for instance, it is not always clear whether information on the quality of these assets is also required).

Clearly, given its principle-based approach, Article 14 of the CBD does not provide for a standardised template. However, considering the wide adoption among industry participants of the Harmonised Transparency Template (HTT), an initiative of the ECBC, well before the introduction of the CBD, some degree of harmonisation in the format used for disclosure requirements already exists *de facto*.

Indeed, this market-oriented, voluntary disclosure tool has become such a well-established industry standard that a few Member States explicitly refer to it in their legislation, either by prescribing a template that is replicating its structure and content, or by referring to it as an eligible medium of disclosure to comply with the transparency requirements.

([165]) For instance, on interest rate and currency risk, some require issuing banks to disclose information on values pre- and post-hedging for both cover assets and outstanding covered bonds. Others require issuing banks to disclose both notional value and replacement cost for derivatives.

([166]) For instance, the weighted average loan-to-value of cover assets, their stress test NPV, details on the maturity profile of both cover assets and covered bonds based on interest fixing periods (as well as effect of triggers on such a distribution), the level of negative maximum cumulative outflow and the exact point in time where it occurs in the 180-days window.

Figure 15: Overview of the different national legislation frameworks on transparency requirements

Member State	Details on credit risk	Details on market/ currency risk	Details on liquidity risk	Information on substitution assets	HTT (replicated/mentioned in the regulation)
Austria	-	-	-	-	No
Belgium	Yes (167)	Yes (168)	Yes (169)	Yes, description and rating level if available	No
Bulgaria	-	-	-	Yes	No
Cyprus	Yes	Yes	Yes	Yes	No
Czechia	-	-	-	Not specified in the answer	No
Denmark	-	Yes (170)	Yes (171)	-	Yes, replication (172)
Estonia	-	-	-	Yes	No
Finland	-	-	-	Yes	No
France	Yes (173)	Yes (174)	-	Yes	No
Germany	Yes (175)	Yes (176)	Yes (177)	Yes	No
Greece	Yes	Yes	Yes	Yes	No
Hungary	-	-	-	Yes	No
Ireland	Yes	Yes	Yes	-	No

(167) Several information: loan seasoning, number of obligors, level of prepayments, level of 30/60/90 days past due, IFRS 9 classification, distribution of loans per loan-to-value and weighted average LTV, type of property, information on the counterparty (for public sector covered bonds).

(168) Distribution of interest percentage, performance of derivatives based on IFRS 9 standards.

(169) Information on distribution of residual maturity of cover assets, level of prepayments, amortisation profile of cover assets and covered bonds.

(170) Separated information for loans and bonds regarding interest rate risk and currency risk. For both risks it is required to disclose amounts before and after hedging and with a breakdown for types of rates/currencies. Information also on the share of fully hedged and share of unhedged loans is required.

(171) Share of match funded loans.

(172) It is also granted the possibility to comply with the transparency requirement by means of the publication of HTT on the bank's website.

(173) The issuer should disclose for immovable property gross amount of unpaid claims, doubtful debts and provisions allocated for each category of claims.

(174) The level and sensitivity of the interest rate position.

(175) Certain information required for all types of covered bond, such as values of cover assets (notional, present value, stressed present value). Additional information required respectively for mortgage, public sector, ship and aircraft covered bond, for instance on mortgage covered bonds details are disclosed on the distribution of primary assets by principal amounts (with different buckets provided in the law), utilisation of collateral property (RRE/CRE incl. sub-sector), weighted average loan-to-value.

(176) Detailed information on maturity profile based on interest fixing periods of cover assets and covered bonds, with granular time buckets defined in the law. Stressed present value amount per foreign currency.

(177) Description of the highest negative cumulative net cash outflow amount and where it occurs in the next 180 days, as well as amount of cover assets eligible for liquidity coverage.

Member State	Details on credit risk	Details on market/ currency risk	Details on liquidity risk	Information on substitution assets	HTT (replicated/mentioned in the regulation)
Italy	Yes ([178])	Yes ([179])	-	-	Yes, reference ([180])
Lithuania	-	-	-	-	Yes, replication
Luxembourg	-	-	-	Yes	No
Netherlands	-	-	-	-	No
Poland	-	-	-	Yes, yearly	No
Portugal	-	-	-	Yes	No
Romania	-	-	-	-	No
Slovenia	-	-	-	-	No
Slovakia	Yes	Yes	Yes	Yes	No
Spain	-	-	-	Yes	No
Sweden	Yes ([181])	Yes ([182])	Yes ([183])	Yes	No

5.3 Conclusions and policy recommendations

The EBA acknowledges that the degree of heterogeneity across Member States concerning the information required for the purpose of the transparency requirements is materially dependent on the existence of different covered bonds models and on differences in the national transpositions of the various provisions of the CBD (e.g. on eligible assets, cover pool composition, coverage and liquidity requirements). Against this background, the EBA is of the view that the principle-based approach of Article 14 of the CBD is overall fit for purpose and that – despite the differences shown above – the disclosure measures currently in place are working sufficiently well, thus not requiring any recommendation at this stage.

The current approach might be re-assessed in the future once a greater level of harmonisation will be achieved across Member States. In this respect, one of the aspects of Article 14 of the CBD that would deserve some further refinement, and clarification is probably the information required under point (d) of this Article (i.e. the details to be provided in relation to various risks (market risk, including interest rate and currency risk, credit risk, and liquidity risk)).

In the meanwhile, pending any possible revision of Article 14 of the CBD in the future, the EBA expects that – as a minimum – the national transpositions of the transparency requirements are tailored to reflect the specificities of the covered bond models used in the respective jurisdiction, instead of

([178]) Maturity profile of both cover assets and covered bonds, maturity buckets set out in the regulation.

([179]) Types and level of derivative hedging, both notional value and replacement cost.

([180]) HTT can be used for compliance purposes, but only provided that the information required therein is sufficient to fulfil also the transparency requirement as specified in the regulation.

([181]) Number of obligors, level of prepayments, level of 30/60/90 days past due, average LTV, type of property.

([182]) Value of cover assets pre and post-hedging, interest fixing periods.

([183]) Information of liquidity flows, including daily net liquid outflow, accumulated net liquid outflow per day and highest net liquid outflow in the next 180 days.

being merely translated from the CBD. It is worth highlighting that this result could be achieved also by means of ancillary instructions that are not strictly considered as part of the legal framework transposing the CBD (e.g. reporting instructions, additional supervisory guidance).

In addition, the existence and wide adoption of the HTT have become valuable in mitigating to some extent the existing heterogeneity, both in terms of content and format of the information that must be provided to investors. However, it is important to stress that the HTT shall only be referred to as an eligible medium to convey the mandatory information, while the type and level of information to be disclosed must be set out by the regulatory framework.

Recommendation 8. *On information disclosure.*

Whilst the EBA endorses the flexibility of the principle-based approach of Article 14 of the CBD, it recommends that the means for information provision are clearly stated by each Member State in their relevant national regulation.

6. COVERAGE REQUIREMENTS

KEY TAKEAWAYS OF THIS CHAPTER

COVERAGE REQUIREMENTS (ARTICLE 15 OF THE CBD)

Covered bonds shall ensure that all related liabilities are taken into account during the lifespan of the instrument. For this reason, the CBD lays down the minimum requirements to cover effectively all the payment obligations. This set of requirements is known as the statutory coverage regime and includes the principles to be adopted to define the coverage of all obligations, the methods for its calculations, the use of over-collateralisation (if any) and the contribution of defaulted collateralised assets. The quantitative foundation of the statutory coverage regime of the CBD is captured by the 'nominal coverage principle', in accordance with the aggregate principal amount of all cover assets must not – at the bare minimum – be lower than that of all outstanding covered bonds. Additionally, Member States are required lay down coverage rules for all non-principal payment obligations (or 'future interest payable'). ([184])

In this regard, **the EBA** has identified as a potential issue the lack of proper definition of the statutory coverage regime at a national level, especially for what concerns future interest payable, and therefore **recommends Member States to lay down a complete set of rules specifying the regime under all its aspects**.

For what concerns the payment of the principal obligations, **the EBA recommends** adjusting outright the nominal amount prudently to take into account value adjustments/risk provisioning, as well as (for listed cover assets) sub-par market prices. In other words, **that the issuer shall be required to take the lower of the residual nominal amount and the accounting amount/current market value.**

As the nominal coverage principle is methodologically unsuitable for of future interest payable, and the recognition of future interest receivable as coverage, the CBD requires Member States to implement a supplementary statutory coverage methodology. The EBA acknowledges the risk stemming from the fact that some Member States handed down this supplementary coverage requirements to issuers, with no clear or publicly available supervisory assessment framework.

Therefore, **the EBA recommends to take into account all future interest payable until the resolution of the covered bond estate** (i.e. the contractual maturity of the longest dated covered bond in circulation at any point in time), **and to discount future interest receivable**. This discounting requirement expands to principal payment obligations and claims, where

([184]) These obligations include the contractual flow payments made in relation of cover pool derivatives, the future interest payable on covered bonds in circulation, and the expected cost of maintenance and winding down of the covered bond programme. Their counterparty (the non-principal payment claims attached to cover assets) is referred instead as 'future interest receivable'.

future interest receivable may cover principal payment obligations and vice versa.

For what concerns instead the payment of the non-principal obligations, **the EBA** acknowledges the risks associated with neglecting some of the unexpected costs and therefore **recommends taking into account all accrued interest-related obligations, as well as any expected winding down costs in case of default**, ensuring the coverage of all obligations foreseen until the maturity of the latest maturing covered bond, and considering the timing of the cashflow in the calculation methodology.

As to the operationalisation of the coverage assessment by the issuer, **the EBA recommends that the calculation frequency shall reflect all potential changes in the parameters of the calculation**, and that **for net-present value (NPV) coverage methodologies the frequency should be no lower than business daily**.

Over-collateralisation is also an important aspect of coverage, as it provides an essential buffer against future adverse fluctuations in the of the cover pool. As such, **the EBA recommends strengthening the conditions for deviating from the statutory over-collateralisation to be provided in accordance with the CRR, whose assessment shall be in no case left to the issuer.**

Lastly, the EBA acknowledges the risks associated with taking into account – for the purpose of the coverage – collateralised cover assets for which a default (in the sense of the CRR) has occurred. Whereas uncollateralised cover assets in CRR-default are banned from general and liquidity coverage contribution, this so far is not the case for defaulted collateralised cover assets, for which **the EBA recommends** instead **to disregard asset-related inflows for the purpose of liquidity and, so far as interest receivable is concerned, general supplementary coverage** (i.e. coverage of future interest payable)**. Under NPV coverage methodologies, the residual maturity should be modified to take into account potential time-to-collection. As to the overall general coverage, the contribution** of the defaulted collateralised cover asset **should be reviewed** by Member States **in light of** domestic experiences regarding **the foreseen duration of the enforcement and the likely reduction in value**.

6.1 Introduction and legal reference

Article 15 of the CBD sets out minimum requirements for the coverage of liabilities attached to the covered bond (estate) of a covered bond programme:

- All liabilities of the covered bonds shall be covered by claims attached to the cover assets.
- The items of covered bond-related payment obligations to be covered at minimum include:
  - principal payment obligations of covered bonds;
  - obligations for the payment of any (i.e. accrued and future) interest on outstanding covered bonds;
  - payment obligations attached to derivative contracts (contractual flow obligations from the derivatives as well as contingent repayment obligation in relation to collateral received from the counterparty as variation margining, if any);
  - the expected costs related to maintenance and administration for the winding-down of the covered bond programme.

- Claims attached to uncollateralised cover assets for which a regulatory default has occurred must not contribute to coverage.
- The 'nominal principal', whereby the aggregate principal amount of all cover assets must not be lower than the aggregate principal amount of outstanding covered bonds, establishes a minimum for coverage of principal payment obligations and a benchmark for alternative coverage calculation principles.

6.2 Coverage requirements frameworks in the EU

The NCA questionnaire collected information on a number of regulatory aspects related to coverage requirements. A thorough overview of the results can be found in Figure 16.

While the nominal principle to calculate the minimum for coverage principal payment obligations is widely adopted, methodologies for coverage of non-principal payment obligations ('future interest payable') vary substantially, from the use of nominal amounts of cover assets. ([185]) This variation occurs via dedicated interest coverage tests, to fully-fledged present-value coverage, with or without the stressing of market rates, to provide also (some degree of) protection of the post-issuer insolvency covered bond estate against the adverse impact of market rate changes on its coverage occurring after estate separation.

In terms of statutory over-collateralisation requirements, a majority of Member States apply EU law baseline requirements (i.e. 5% for 'European Covered Bond (Premium)' bonds, and 10% for covered bonds covered by exposures to public undertakings). Some Member States apply lower minimum over-collateralisation for 'European Covered Bond (Premium)' bonds (mostly 2% being the CRR minimum level). A minority of Member States apply minimum over-collateralisation in excess of that set, as the baseline of EU law. Justifications for lowering the statutory over-collateralisation for 'European Covered Bond (Premium)' bonds vary depending on the understanding of what may be seen to qualify, with some going even beyond the perimeter already implied in Article 129(3a)(3)(a) of the CRR.

There is also heterogeneity regarding the conditions for removability of voluntary over-collateralisation (i.e. the collateral that is required neither by statutory law nor by terms and conditions of the covered bond) and for the reporting classification of such collateral (encumbered or unencumbered). Safeguards to prevent free removability usually require the consent of the CPM and a specific permission – specified in the terms and conditions – to allow for the removal without replacement other than by way of amortisation. In one occurrence, the cover assets provided initially may only be replaced in case of subsequent ineligibility, but not simply removed. In many jurisdictions, voluntary over-collateralisation is instead freely removable, even where de-registration would formally require CPM consent (who yet may not withhold consent unduly as long as statutory coverage still is present after removal). Reporting classification varies from unencumbered, to encumbered, to the extent necessary to support existing external ratings, to fully encumbered without further qualification.

As to the contribution to coverage of defaulted collateralised cover assets, a majority of responses indicated a less than full contribution, despite Article 15(4)(2) of the CBD only de-recognising uncollateralised defaulted cover assets for coverage purposes.

([185]) If the corresponding responses were to be taken at face value, probably the most conservative type of coverage regime, effectively ignoring time-value-of-money aspects (and the associated reinvestment risk or need for bridge-funding), but, for non-negative yield curves, not to the detriment of covered bond investors, and providing for additional protection by interest receivable being completely ignored for coverage calculation purposes.

Figure 16: Overview of the different national legislation frameworks on coverage requirements

Member State	Principle(s) of quantitative coverage	Corresponding methodology	Expected cost of programme wind-down	Permanence of coverage requirement and frequency of assessment by issuer (186)	Minimum over-collateralisation / Justification for over-collateralisation < 5%	Removability of voluntary over-collateralisation / Asset encumbrance reporting	Coverage contribution of defaulted collateralised cover assets (187)
Austria	Nominal	-	Literal transposition incl. lump sum	-	2% / 'Formal approach' (188)	Removable subject to CPM consent / -	-
Belgium	Nominal and amortisation (189)	Specified	Literal transposition incl. lump sum	Constantly / At least business-daily	5% (190)	Freely removable / Encumbered (191)	Less than full recognition (192)
Bulgaria	Nominal and NPV	-	Literal transposition incl. lump sum	-	5%	Removability only subject to notification to CB investors and CA / -	-
Cyprus	Nominal (193)	-	Literal transposition incl. lump sum	Constantly	10% (194)	Freely removable given that coverage requirements are met and/or unencumbered	Not recognised

(186) The question to NCAs aimed at what the frequency of necessary compliance by issuers with statutory coverage requirements is (permanent vs. periodic) and what frequency of cover calculation is required from issuers to assess sufficient coverage (business-daily vs. longer intervals).

(187) The question to NCAs omitted reference to the coverage contribution of 'defaulted' collateralised cover assets.

(188) Unspecified.

(189) The 'amortisation test' also includes interest payable and cost of wind-down of covered bond estate. There is no present value calculation for payments due or expected income, however, to account for the timing of the cash-flows, but it is expected that the credit institution has sufficient assets/income to cover the cumulative or individual liabilities at or up to any point in time.

(190) Only 'European Covered Bond (Premium)' covered bonds allowed. No double counting of cover assets for over-collateralisation and interest coverage under amortisation principle.

(191) To the extent necessary to support CB external ratings.

(192) For Article 178 of the CRR: 100% haircut. For 30+dpd: 50% haircut.

(193) 'Other' methods subject to competent authority approval.

(194) Article 6(4) of the CBD.

Member State	Principle(s) of quantitative coverage	Corresponding methodology	Expected cost of programme wind-down	Permanence of coverage requirement and frequency of assessment by issuer [186]	Minimum over-collateralisation / Justification for over-collateralisation < 5%	Removability of voluntary over-collateralisation / Asset encumbrance reporting	Coverage contribution of defaulted collateralised cover assets [187]
Czechia	Nominal [195]	For nominal only [196]	Specified lump sum [197]	-	2% /	Freely removable / -	-
Denmark	Nominal [198]	DFSA inspection	Literal transposition incl. lump sum	-	2% [199]/ CRoCP [200] / Formal approach [201]	Free removability w/o CA consent / unencumbered	Full recognition
Estonia	Nominal [202]	For nominal only	Literal transposition w/o lump sum	-	5% [203]	Freely removable / -	-
Finland	Other [204]	Specified	Literal transposition w/o lump sum	Constantly / -	Article 129(3a) of the CRR [205]/ 5% / 'Formal approach' [206]	Freely removable / -	-

(195) Derivative contracts with IFRS fair value as claim only up to the received collateral.

(196) Derivative contracts at fair value.

(197) 1% of nominal of covered bonds outstanding.

(198) At outset. Ongoing for match funded covered bonds possibility to cover the fair value of principal payment obligations by the fair value of excess future interest receivables as per Article 15(7) of the CBD.

(199) 'European Covered Bond (Premium)' covered bonds.

(200) CRoCP (Capital Requirement of Cover Pool) for 'European Covered Bond' covered bonds: 8% x RWEA cover pool.

(201) CRoCP for 'European Covered Bond (Premium)' covered bonds and balance principle (requiring over-collateralisation in case of market risk exceeding regulatory limits).

(202) Also for interest payable and net derivative liabilities.

(203) Also under at least quarterly stress test.

(204) Lower of nominal value or present-value of cover assets shall at least be 102%, 105% if conditions of Article 129(3a)(3) of the CRR are not met, of the higher of nominal value or present-value of covered bonds outstanding.

(205) For 'European Covered Bond (Premium)' covered bonds: in accordance with Article 129(3a) of the CRR.

(206) Unspecified. Requirement on the issuer assessed in permission proceedings.

Member State	Principle(s) of quantitative coverage	Corresponding methodology	Expected cost of programme wind-down	Permanence of coverage requirement and frequency of assessment by issuer ([186])	Minimum over-collateralisation / Justification for over-collateralisation < 5%	Removability of voluntary over-collateralisation / Asset encumbrance reporting	Coverage contribution of defaulted collateralised cover assets ([187])
France	Prudential accounting ([207])	-	Specified lump sum ([208])	Constantly / -	5%	Freely removable w/o CPM consent / -	-
Germany	Nominal and (stressed) NPV	Specified	Specified lump sum ([209])	Constantly / At least business-daily ([210])	2% ([211]) / 5% ([212]) / MLV ([213])	Freely removable ([214]) / Encumbered	Full recognition ([215])
Greece	Nominal, (stressed) NPV, ICT ([216])	Specified	Specified lump sum ([217])	Constantly	5%	-	Less than full recognition ([218])

([207]) Assets that fall within the prudential scope of consolidation are downwardly risk-weighted for their contribution to coverage requirements.

([208]) 3bps x weighted average residual maturity CB x aggregate nominal amount CB.

([209]) 2% (stressed) present value over-collateralisation.

([210]) At least weekly for stressed present-value coverage.

([211]) Mortgage covered bonds and public sector covered bonds (both 'European Covered Bond (Premium)'), 2% nominal over-collateralisation in addition to 2% present value over-collateralisation (lump sum wind-down costs), no double counting nominal and present value over-collateralisation.

([212]) Ship covered bonds ('European Covered Bond (Premium)'), and aircraft covered bonds, 5% nominal over-collateralisation in addition to 2% present value over-collateralisation (lump sum wind-down costs), no double counting nominal and present value over-collateralisation.

([213]) Mortgage lending valuation required for primary cover assets of mortgage covered bonds, ship covered bonds and aircraft covered bonds.

([214]) De-registration requires CPM consent, who is duty-bound to monitor sufficient (statutory) coverage, only, thus is perceived not to be able to withhold consent unduly.

([215]) 90+ dpd may prompt reassessment of MLV for collateral property; amounts of cover assets value adjusted or risk provisioned against 100% haircut.

([216]) Amounts of interest receivable vs. payable for 12 months.

([217]) Minimum 1% nominal of outstanding covered bonds.

([218]) For Article 178 of the CRR and 90+ dpd: 100% haircut.

Member State	Principle(s) of quantitative coverage	Corresponding methodology	Expected cost of programme wind-down	Permanence of coverage requirement and frequency of assessment by issuer [186]	Minimum over-collateralisation / Justification for over-collateralisation < 5%	Removability of voluntary over-collateralisation / Asset encumbrance reporting	Coverage contribution of defaulted collateralised cover assets [187]
Hungary	Nominal [219] and (stressed) NPV	Specified	Specified lump sum [220]	Constantly / At least business-daily	2% / Other [221]	Removable subject to CPM consent / Encumbered [222]	-
Ireland	Prudent market value, [223] ICT	-	Literal transposition incl. lump sum	-	3% [224] / 10% [225] / Formal approach [226]	Removable subject to CPM consent / Encumbered	-
Italy	Nominal, NPV and ICT	Specified	Literal transposition incl. lump sum	Constantly / -	5% [227]	Freely removable w/o CPM consent / -	-
Lithuania	Nominal		Literal transposition incl. lump sum	-	5% [228]	Freely removable / encumbered	Less than full recognition [229]

[219] Incl. ICT for accrued interest receivable vs. payable; value adjustments reduce principal and interest receivable.

[220] 1‰ of covered bonds outstanding.

[221] Daily monitoring of coverage.

[222] With LCR-like exceptions.

[223] Prudent market valuation of cover pool for coverage of principal payable and expected cost of programme's wind-down, ICT with amount of interest receivable vs. payable over next 12 months.

[224] Covered bonds issued by designated mortgage credit institutions and designated public credit institutions.

[225] Covered bonds issued by designated commercial mortgage credit institution.

[226] Prudent market valuation.

[227] 'European Covered Bond (Premium)' covered bonds.

[228] Only 'European Covered Bond (Premium)' covered bonds allowed.

[229] For 90+ dpd and LTV < 50%: haircut 30%; for 90+ dpd and LTV > 50%: haircut 60%; for 180+ dpd: haircut 100%.

Member State	Principle(s) of quantitative coverage	Corresponding methodology	Expected cost of programme wind-down	Permanence of coverage requirement and frequency of assessment by issuer ([186])	Minimum over-collateralisation / Justification for over-collateralisation < 5%	Removability of voluntary over-collateralisation / Asset encumbrance reporting	Coverage contribution of defaulted collateralised cover assets ([187])
Luxembourg	Nominal and NPV ([230])	-	Literal transposition incl. lump sum	-	5% ([231])/10% ([232])	-	-
Netherlands	Nominal	Specified ([233])	Specified lump sum ([234])	-	5%	Freely removable / Unencumbered	-
Poland	Nominal, ICT ([235])	Specified	Literal transposition w/o lump sum	Constantly / At least business-daily	5%	Removable subject to CPM consent	-
Portugal	Nominal ([236])	For nominal only	Literal transposition incl. lump sum	Quarterly ([237])	5% ([238])/10% ([239])	Removable in accordance with terms and conditions / encumbered	-
Romania	Accounting ([240])	Specified ([241])	-	Constantly / At least business-daily	129(3a) /5%	No removability / -	

([230]) NPV synonymous for 'current value' coverage.

([231]) Mortgage bonds, moveable-property covered bonds and renewable energy covered bonds.

([232]) Public sector covered bonds.

([233]) Coverable obligations to include principal payable, interest payable, payment obligations in relation to derivative contracts, expected cost of wind-down of programme.

([234]) Higher of 4bps of nominal covered bonds outstanding or 400.000 euro.

([235]) Point-in-time comparison of interest receivable and payable.

([236]) Mandatory, others (NPV, stressed NPV, prudent market valuation) permissible subject to nominal minimum as per Article 15(6)(2) of the CBD.

([237]) In addition, issuers shall also communicate the information to the NCA every six months (or upon request by the NCA itself).

([238]) Article 129(3a) of the CRR.

([239]) Article 6(4) of the CBD.

([240]) Over-collateralisation indicator by way of NPV.

([241]) Including accounting value for coverable obligations (own credit risk).

Member State	Principle(s) of quantitative coverage	Corresponding methodology	Expected cost of programme wind-down	Permanence of coverage requirement and frequency of assessment by issuer (186)	Minimum over-collateralisation / Justification for over-collateralisation < 5%	Removability of voluntary over-collateralisation / Asset encumbrance reporting	Coverage contribution of defaulted collateralised cover assets (187)
Slovenia	Nominal and NPV	Specified (242)	Literal transposition incl. lump sum	Constantly / At least monthly	2% (243)/5% (244) / MLV	Removable subject to CPM consent / Encumbered	-
Slovakia	Nominal (245)	-	Literal transposition, incl. optional lump sum	- / Last day of month	5% (246)/10%	Removable in accordance with terms and conditions / -	-
Spain	Nominal (247)	Specified (248)	Literal transposition incl. mandatory lump sum	-	5% (249)/10% (250)	Removable in accordance with terms and conditions with CPM consent / Encumbered	Less than full recognition (251)
Sweden	Nominal and NPV	Specified	Literal transposition including lump sum	Constantly / At least business-daily	2% / 'Formal approach' (252)	Freely removable w/o CA consent / Unencumbered	Less than full recognition (253)

(242) Monthly calculation frequency.

(243) Only 'European Covered Bond (Premium)' covered bonds allowed. 2% over-collateralisation in case of MLV (issuer choice, no regulatory MLV).

(244) In case of no MLV: 5% minimum over-collateralisation nominal and present value.

(245) Also for accrued interest Lower of residual nominal amount and fair value for substitution and liquidity buffer assets.

(246) 'European Covered Bond (Premium)' covered bonds.

(247) Short-term exposures to credit institution and traded fixed-income instruments: at market value.

(248) At least annual coverage assessment by issuer.

(249) Mortgage, public sector and internationalisation covered bonds (eligible under the label of 'European Covered Bond (Premium)').

(250) Article 6(4) of the CBD.

(251) For 'European Covered Bond (Premium)' covered bonds: 100% haircut due to Article 129 of the CRR exposure class shift of collateralised cover asset to Article 127 of the CRR.

(252) There is a parallel mandatory 2% coverage that applies to both nominal and NPV calculation. Furthermore, the SFSA has implemented national rules that requires every institution to conduct at least an annual sensitivity analysis (in practice monthly) on the cover pool where real estate prices decrease up to 30%.

(253) 100% haircut for cover assets 60+ dpd.

6.3 Policy assessment

Before the introduction of the CBD in 2019, coverage requirements were implicitly stated by Article 52(4) of the UCITS Directive ([254]) (and already in Article 22(4) of the previous UCITS Directive), ([255]) which captured only the principal and interest-accrued of covered bonds in circulation. Thus, for full time-value-of-money recovery by covered bond investors, coverage previously relied conceptually on an assumption of immediate settlement upon issuer default.

The entry into force of the CBD has introduced the principle of bankruptcy remoteness (Article 5 of the CBD) (i.e. the idea that the covered bonds and the cover pool under new management would 'carry on' outside the insolvency proceedings over the issuer's general estate and would respect the contractual payment schedule thanks to an 'orderly wind-down' of the estate).

This principle relies on the availability of sufficient coverage for all payment obligations that the covered bond estate may face during this potentially significantly extended wind-down period. Thus, the purpose of the coverage requirements provided for in Article 15 of the CBD is precisely the immunisation of the covered bond estate against the risk of separate insolvency, which otherwise would go against the bankruptcy remoteness paradigm. ([256])

Consequently, Article 15(2) of the CBD requires coverage of 'all liabilities of the covered bonds', since it is assumed that any payment obligation of the covered bond estate may, if unsettled on schedule, constitute grounds of ending the 'orderly wind-down' of the covered bond estate

A first issue identified by the EBA is the definition of 'all liabilities', as some of the payment obligations (like future interest payables or payment obligations due to derivative transactions, the amount of which may vary due to changes in market price parameters) are typically not captured by principal or nominal coverage.

Also, the orderly wind-down of the covered bond estate will produce additional costs, ([257]) for which the insolvent issuer will no longer provide funds. Consequently, in order for the covered bond estate not to risk fire sales, all of these payment obligations not expressed in the covered bonds' nominal amount require coverage, as clearly stated in Article 15(2) of the CBD.

In this regard, the EBA acknowledges that many jurisdictions do not specify, neither in statutory law nor supervisory guidance, the methodologies to calculate the coverage of non-principal-related covered bond payment obligations and leaving instead the transposition requirements of Article 15(2) of the CBD to issuers via contractual definition. This lack of specification sometimes extends even to the lump-sum approach, which is one of the choices for determining the expected cost of maintenance and winding down of the covered bond programme as per Article 15(3)(1)(d) of the CBD, a choice that was clearly aimed – in the intention of the CBD – to be completed by national transposition.

Given that the extent of statutory coverage is likely to become a contentious issue between the covered bond estate and the general insolvency estate of the failed issuer at the time of estate separation, the absence of a clearly specified

([254]) Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) (OJ L 302, 17.11.2009, p. 32, ELI: http://data.europa.eu/eli/dir/2009/65/oj).

([255]) Council Directive 85/611/EEC of 20 December 1985 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) (OJ L 375, 31.12.1985, p. 3, ELI: http://data.europa.eu/eli/dir/1985/611/oj).

([256]) As may be evidenced by the 'new' requirement of coverage of the 'expected costs related to maintenance and administration for the winding-down of the covered bond programme' in Article 15(3)(1)(d) of the CBD.

([257]) Including staffing for cover asset administration, remuneration for a special administrator where such function is foreseen, operating expenses for software licenses, platform access, as well as mundane aspects like insurance, cleaning services or electricity.

coverage regime would negatively impact on the orderly wind-down of the covered bond estate. In addition, even in a non- 'jump to default' exit scenario of the covered bond issuer such need for specification may even arise in the run-up to the default, when tapping into the voluntary over-collateralisation – by way of using the cover assets or by additional issuance – becomes inevitable for the issuer to face adverse funding conditions.

The general outline of taking into account principal claims and obligations as well as future interest payable and receivable in a methodologically sound approach to coverage are reported in Figure 17.

Figure 17: General outline of the approach to coverage for principal and non-principal obligations

		Requires	
Utilisation of claims attached to the cover assets for the payment of	**As coverage of payment obligations for**	**taking into account full time to longest CB maturity**	**Discounting of all included claims and obligations from scheduled payment date**
Principal	Principal		
	Non-principal	x	
Non-principal	Principal		x
	Non-principal	x	x

The EBA has also identified a potential issue arising from the technical implementation of the coverage requirement. While NCAs usually define such requirement as permanent (i.e. sufficient coverage has to exist 'at all times'), this is in practice not mirrored in the frequency with which the issuer performs the coverage calculation. In most cases, this may be justified by factors such as voluntary over-collateralisation, but the potential sources of impact on coverage are manifold, not all of which are due to scheduled changes. ([258]) Therefore, for a statutory coverage regime, one would expect a very high, typically business-daily assessment frequency. Alternatives, forecasting and monitoring techniques, do not necessarily appear less onerous on issuers.

The EBA has also analysed the opportunity of an outright removal of the possibility to lower statutory over-collateralisation of 'European Covered Bond (Premium)' bonds to below 5% as granted by Article 129(3a)(3) of the CRR. However, on the ground that Basel does not require over-collateralisation levels to be statutory, and in light of the presence of justifications for such deviation at a national level, as well as in view of the future evolution of the valuation framework for 'European Covered Bond (Premium)' bonds, the EBA deems it more appropriate to revisit and strengthen the conditions for such deviation, and to preclude that the compliance decision whether the justification for lowering persists be left to issuers.

As to the removal of voluntary over-collateralisation, the EBA views the prior consent of the CPM as a theoretically appropriate safeguard, even if merely aimed at raising awareness of the change in coverage. However, given that the appointment of a CPM is not a legal obligation, and that the timing of the consent of other external parties (by the NCA or the issuer's annual auditor) may not be compatible with the operational needs of the removal, the EBA does not envisage room for the imposition of additional restrictions to the legal framework.

Finally, the EBA acknowledges that the main issue of the contribution of defaulted collateralised cover assets for coverage purposes lies in the timing of payment inflows of the claims attached

([258]) For instance: scheduled amortisation payments, pre-payments, cover pool additions/removals, flow payments under derivative contracts, market price changes impacting on coverage of future interest payable as well as repayment obligations of received collateral from derivative contracts.

to those assets, irrespective of whether they are collateralised or not, even if such claims may be recoverable at some point in time. This issue alone would call for de-recognition of the associated inflows or scheduled payments for liquidity or NPV/interest coverage purposes. Beyond this aspect, Member States are best to decide whether time-value-of-money considerations in light of duration of enforcement proceedings, or experiences with a regularity of damage-induced depreciation of enforced collateral assets warrant defaulted collateralised cover assets to contribute also to general coverage at less than full value only. The share of defaulted cover assets must be disclosed in accordance with Article 14(2)(1)(g) of the CBD, so issuers may feel incentivised to remove such assets from the cover pool before having to disclose such information.

6.4 Conclusions and policy recommendations

In view of the identified issues, the EBA has elaborated recommendations on the following aspect of coverage requirements:

- coverage of future interest payable (including certain methodological choices should not be left to issuers);
- nominal coverage for the purpose of accounting value adjustments or risk provisioning, as well as the recognition of sub-par market prices of listed cover assets;
- technical implementation of coverage requirements, as to the calculation method and the frequency of such calculation;
- stronger justifications to lower statutory over-collateralisation for 'European Covered Bond (Premium)' bonds to less than 5%;
- we-recognition of inflows of defaulted collateralised cover assets for liquidity, NPV and interest coverage.

Recommendation 9. *On the statutory coverage regime.*

National regulation shall sufficiently specify the statutory coverage regime, including the methodology adopted to cover non-principal payment obligations/future interest payable, including expected winding-down costs, and the conditions for lowering statutory over-collateralisation in accordance with Article 129(3a)(3) of the CRR. As an interim solution, NCAs shall assess the adequacy of the issuer's methodology on an ad hoc basis and publish the criteria used for this assessment.

Recommendation 10. *On the nominal principle.*

Claims to the payment of the principal of cover assets shall be considered with the lower of their residual nominal amount and the associated accounting value net of adjustments and/or risk provisioning, or, in case of cover assets listed on a recognised exchange, their market price. Where the covered bond may be redeemed at less than the residual principal amount, that value shall be used instead. Conversely, where the covered bond may be redeemed at an amount exceeding the residual principal amount, that value shall be used instead.

Recommendation 11. *On the method of coverage of non-principal payments.*

The methodology to calculate coverage of non-principal payments shall consider all obligations until the maturity of the latest maturing covered bond; where such methodology allows for claims other than those to the payment of the principal to cover these other obligations, it shall take into account the time-value-of-money or timing of the cashflows by way of discounting future payments.

Recommendation 12. *On the frequency of the coverage assessment.*

The frequency of the assessment of sufficient coverage shall reflect the frequency of potential changes to the parameters of the coverage calculation (e.g. changes by way of: scheduled amortisation, unscheduled prepayments, impact of changes to interest rates or forex rates on variable rate/forex denominated cover assets or coverable obligations including contractual flows from derivatives, contingent repayment obligation for collateral received by derivative counterparty , coverable amount of collateral received, spot discount rates and/or yield curves, spot forex rates, cover pool composition due to amortisation or addition or removal of assets). For present-value coverage, the recommended frequency of issuer assessment of sufficient coverage should be business-daily.

Recommendation 13. *On the lowering of statutory over-collateralisation.*

The conditions for lowering statutory over-collateralisation in accordance with Article 129(3a)(3)(a) of the CRR shall be strengthened, and the assessment of whether these conditions are met shall not be left to the issuer.

The overarching principle shall be that the national covered bond regime applies statutory rules (on coverage eligibility, coverage calculation) more conservative than those applied mandatorily by the CBD and Article 129 of the CRR in terms of credit risk of the cover pool, (i.e. rules aimed at reducing the implied loss-given-default of the covered bond vis-à-vis that of any minimum requirement-compliant 'European Covered Bond (Premium)' bonds).

If, for purposes of valuation of cover assets for covered bonds qualifying for the preferential treatment in accordance with Article 129 of the CRR, an alignment to prudent valuation as defined by Article 229 of the CRR (or a more conservative mortgage lending valuation) is or will be required, it is recommended to re-assess the aforementioned conditions in light of the new level of risk (which is likely to be reduced). An MLV-related lowering of statutory over-collateralisation should then only be permissible based on empirical evidence of a sufficient margin of conservatism of MLV vis-à-vis prudent valuation.

Recommendation 14. *On defaulted collateralised cover assets.*

Collateralised cover assets for which a default has occurred in accordance with Article 178 of the CRR, shall be treated for coverage purposes under the CBD as follows:

- *For liquidity coverage purposes as per Article 16 of the CBD, liquidity inflows associated to such assets shall not be taken into account when determining the maximum cumulative net liquidity outflow. Similarly, such assets shall not qualify as liquidity buffer cover assets as per Article 16(3) of the CBD.*
- *For general coverage of claims to the payment of non-principal amounts of such assets as per Article 15 of the CBD, future interest receivable of such assets shall be disregarded.*
- *For overall general coverage purposes per Article 15 of the CBD, Member States shall assess whether to limit coverage contribution of such assets in view of the long duration of the enforcement of the related proceedings, or the likely poor conditions of properties (in case of immovable properties) subject to enforcement proceedings.*

7. COVERED BOND PUBLIC SUPERVISION

KEY TAKEAWAYS OF THIS CHAPTER

COVERED BOND PUBLIC SUPERVISION (TITLE III OF THE CBD)

The CBD devotes particular attention to the supervision of covered bonds, both at the issuer and product level. Member States are required to appoint a national authority in charge of covered bond supervision in accordance with the CBD, including for purposes of granting permission to issue covered bonds, either at the programme or single-issue level (or both), depending on the national framework. The said authority shall also have sanction powers in case of a breach of law, and with the publication of the penalties under certain restrictions (for instance, in case of verified reputational risks and market disruption).

The EBA thoroughly analysed the various national supervisory systems and **acknowledges a certain degree of heterogeneity in practices**. However, such differences are to be largely attributed to the different covered bond models in place in the various Member States and are therefore of no concern. For this reason, this Chapter is limited to an overview of the different supervisory systems, **without any recommendations in terms of policy action**.

7.1 Introduction and legal reference

The main purpose of Title III of the CBD is to regulate the conditions under which credit institutions can issue covered bonds as a financing tool, by establishing specific product supervision to ensure a high level of investor protection.

The existence of a public supervision framework for covered bonds was provided for by Article 52(4) of Directive 2009/65/EC ([259]) (and by its predecessor Directive 85/611/EEC). ([260]) However, the Directive did not specify the nature and content of this supervision, nor the authorities that should perform it. It was therefore essential to have harmonised principles for covered bond public supervision, and to clearly set the tasks and responsibilities of the national competent authorities.

([259]) Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) (OJ L 302, 17.11.2009, p. 32, ELI: http://data.europa.eu/eli/dir/2009/65/oj).

([260]) Council Directive 85/611/EEC of 20 December 1985 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) (OJ L 375, 31.12.1985, p. 3, ELI: http://data.europa.eu/eli/dir/1985/611/oj).

As covered bond public supervision is distinct from the prudential supervision of credit institutions in the EU, Member States shall appoint dedicated NCAs (Article 18(1) of the CBD). However, to ensure consistency in the application of covered bond public supervision across the EU, a certain degree of cooperation with the authorities performing the general supervision of credit institutions and with the resolution authorities is demanded, where applicable (Article 25 of the CBD).

Covered bond public supervision includes the competence and responsibility of granting permission to issue covered bonds (Article 19 of the CBD). As only credit institutions may obtain such permission, authorisation as a credit institution is a prerequisite for it. Whereas in Member States participating in the Single Supervisory Mechanism, the European Central Bank is tasked with the authorisation of credit institutions in accordance with Article 4(1)(a) of Council Regulation (EU) No 1024/2013, ([261]) only the designated national authorities can grant permission to issue covered bonds and exercise covered bond public supervision.

Covered bond supervision includes the ongoing monitoring of the features of the programme, the coverage requirements, and the quality of the cover pool to ensure compliance with the requirements laid down in the provisions of national law transposing the Directive, even in the presence of a cover pool monitor (Article 22 of the CBD). The NCAs must be able to obtain the information to assess the compliance with these requirements, investigate possible breaches of those requirements, and impose administrative penalties and other administrative measures in accordance with the provisions of national law transposing Article 23 of the CBD.

For this purpose, Member States shall ensure that the competent authorities have the expertise, resources, operational capacity, powers and independence necessary to carry out the functions relating to covered bond public supervision.

7.2 The covered bond public supervision frameworks in the EU

The questionnaire gathered information about the tasks and procedures of the NCAs related to granting covered bond programme permission, as well as the notifications transmitted to the EBA in accordance with Article 18(2) and Article 24(9) of the CBD. A thorough overview of the results can be found in Figure 18.

In most Member States, the prudential supervisor of the covered bond issuers has been designated as competent authority also for covered bond supervision. Where market supervisory authorities have been designated, a prior opinion of the prudential supervisor for granting permission of a covered bond programme is required. In some countries the market authority also has some competences on the regulation of the prospectus for the purpose of investor protection. In this regard, funding by covered bonds should be coherently described in the prospectus with the covered bond programme of the issuer, as well as the statutory framework under which it is issued.

Additional tasks of NCAs are the appointment or approval of appointment of a CPM, including remuneration, dispute settlement and dismissal, the approval of methodological changes for coverage calculation, ([262]) and the granting of exceptions for certain requirements established at the national level. In some countries, NCAs are also empowered with various supervisory powers.

There is a certain degree of heterogeneity as to the level at which covered bond business needs are permitted between Member States, most commonly due to the choice of issuance model. Whereas all covered bond issuers must require prior authorisation as a credit institution – the competence for which rests solely within the ECB (via the Single Supervisory Mechanism) – the permission to issue covered bonds can be granted

([261]) Council Regulation (EU) No 1024/2013 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions (OJ L 287, 29.10.2013, p. 63, ELI: http://data.europa.eu/eli/reg/2013/1024/oj).

([262]) For instance, the utilisation on the NPV principle.

either at the covered bond programme level (by far the most common level of permission for universal banks) ([263]) or, in a few cases, at the issuer (i.e. legal entity) level. In the latter case, the structure of the legal entity usually determines the permission of issuing covered bonds (for instance, in the case of specialised mortgage credit institutions).

([263]) In this case, subsequent issuances under a permitted programme usually do not require additional permission, except in the case of modifications.

Figure 18: Overview of the different national legislation frameworks on cover pool supervision

Member State	Designated CA	Division of duties	Supervisor approval needed	Separate permission (in addition to banking licence) for single CB programme	Publication of administrative penalties
Austria	Market authority	-	-	Yes	Yes
Belgium	Banking authority	Yes (264)	Yes (265)	Yes (266)	Yes (267)
Bulgaria	Banking authority	Structural unit within banking department	-	No	Yes
Cyprus	Banking authority	Mixed (268)	Yes	Yes	Yes
Czechia	Banking authority	Structural unit within financial market supervision department	Yes	Yes	Yes
Denmark	Banking authority	Structural unit within banking department	No	Yes (269)	Yes
Estonia	Banking authority	-	-	Yes (270)	No
Finland	Banking authority	Structural unit within banking department	No	Yes (271)	Yes

(264) The verification of the prospectus is the responsibility of the market authority (FSMA), while all other supervisory tasks are the responsibility of the supervisory teams within the banking authority (NBB).

(265) Approval and dismissal of cover pool monitor; role of supervisor in setting a covered bond limit in case there is a breach of specific criteria, appointment of the special administrator and approval of the special administrator in specific situations.

(266) For significant institutions: the ECB provides approval of the general license to issue covered bonds and NBB provides approval for the specific license of a covered bond programme (including significant modifications to the covered bond programme, for instance an increase in size of the programme).

(267) Publication of the decisions depends on the circumstances. The supervisor can decide to publish decisions without mentioning names. However, the information can become public as soon as the reasons justifying anonymity cease to exist.

(268) Financial Conduct Division, in collaboration with Division Market Operations where needed.

(269) As specialised mortgage credit institution.

(270) Authorisation to issue covered bonds. In addition, any modification is treated as if it were a new covered bond programme.

(271) Authorisation to issue covered bond.

Member State	Designated CA	Division of duties	Supervisor approval needed	Separate permission (in addition to banking licence) for single CB programme	Publication of administrative penalties
France	Banking and insurance authority	Task within the unit in charge of the supervision of the parent entity	-	Yes (272)	Yes (273)
Germany	Banking authority	Mixed (274)	Yes (275)	Yes (276)	Yes (277)
Greece	Banking authority	-	Yes	No	Yes
Hungary	Banking authority	-	-	Yes (278)	Yes
Ireland	Banking authority	-	-	Yes (279)	Yes (280)
Italy	Banking authority	Yes (281)	Yes (282)	Yes	Yes

(272) As specialised financing company.

(273) In exceptional cases, the Sanctions Committee has the power to decide not to publish the administrative penalties.

(274) Dedicated unit (cover pool auditing, CPM approval and remuneration) and supervisors from prudential supervision.

(275) If exceeding the 20% limit for (necessary) coverage through supplementary cover assets in case of winding-down of the Pfandbrief business of a certain type of Pfandbriefe (sporadically used, as it requires waiving of the corresponding permission); changes to the present value calculation methodology applied, certain deviations from requirements for ordinary cover assets of ship Pfandbriefe and for aircraft Pfandbriefe; some procedural participations of BaFin in the special administrator proceedings.

(276) Separate permission per type of covered bond programme, determined by primary cover asset (mortgage, public sector, ship, aircraft) required.

(277) Publication upon measure being no longer contestable, possibility for anonymisation under certain conditions (e.g. 'shaming' effect deemed excessive for infringement), possibility to suspend publication (e.g. for financial stability considerations).

(278) Mortgage banks.

(279) Registered as a designated credit institution.

(280) Anonymised under certain circumstances (e.g. because of a subsequent negative impact on financial stability).

(281) The verification of the prospectus is the responsibility of the market authority (Consob), while all other supervisory tasks are the responsibility of the supervisory teams within the banking authority (Bank of Italy).

(282) Authorisation by the Bank of Italy for each single new covered bond programme.

Member State	Designated CA	Division of duties	Supervisor approval needed	Separate permission (in addition to banking licence) for single CB programme	Publication of administrative penalties
Lithuania	Banking authority	Mixed (283)	Yes	Yes (284)	Yes (278)
Luxembourg	Banking authority	-	Yes	Yes (285)	Yes (278)
Netherlands	Banking authority	-	-	No	Yes
Poland	Banking authority	Structural unit within banking department	Yes (286)	Yes (287)	Yes (278)
Portugal	Market authority	-	Yes	Yes	Yes
Romania	Banking authority and Securities Market authority	-	Yes	Yes	Yes
Slovenia	Banking authority and Securities Market authority	Close cooperation required (288)	Yes (289)	Yes	Yes
Slovakia	Banking authority	Yes (290)	No	Yes (291)	Yes

(283) No dedicated unit as no covered bond programme has been issued so far. In any case, approval and supervision team would bring together employees from various units with the necessary competencies: methodological, bank prudential supervision, product supervision, etc.

(284) Notification required on individual issues.

(285) As per Article 14(1) of the Law of 8 December 2021 relating to the issuance of covered bonds.

(286) Appointment and dismissal of the external cover pool monitor.

(287) The PFSA approves base prospectuses in accordance with Regulation 2017/1129 and national laws.

(288) a) Preliminary opinion of Securities Market Agency to the Bank of Slovenia on the issuance and withdrawal of permissions, issuance of regulations, appointment and dismissal of special administrator; b) mutual provision of data, information, documents and reports, which are necessary for the implementation of supervisory tasks

(289) a) Permission for the appointment and dismissal of the cover pool monitor and its deputy; b) appointment and dismissal of a special administrator in the event of insolvency or resolution. In both cases prior consultation with Securities Market Agency is required.

(290) Verification of the prospectus is the responsibility of the market department with cooperation in the Banking department, all other supervisory and regulatory tasks are the responsibility of separate sections within the banking supervision departments (units for permissions and sanctions, ongoing and on-site supervision etc. from prudential supervision).

(291) The bank shall obtain the prior approval of Národná Banka Slovenska for each covered bond programme individually. There are four programmes in the Slovak covered bond framework (not equal to issuance programme) according to the type of primary assets. Also, approval and dismissal of cover pool monitor.

Member State	Designated CA	Division of duties	Supervisor approval needed	Separate permission (in addition to banking licence) for single CB programme	Publication of administrative penalties
Spain	Banking authority	Structural unit within banking dept.	Yes ([292])	No	Yes ([278])
Sweden	Banking authority	Structural unit within banking dept	- ([293])	Yes	No

([292]) Permission for the appointment and dismissal of the external cover pool monitor and for the maturity extension of the covered bonds in maturity extension structures. The competent judge, by reason of the insolvency, shall appoint a special administrator, after consulting the Banco de España, from among the persons shortlisted by the Spanish executive resolution authority.

([293]) Not applicable because the NCA is also the prudential supervisor of the institution.

7.3 Conclusions and policy recommendations

In each Member State, covered bond supervision is the prerogative of the NCA. The scope of the supervision and the nature of the tasks vary depending primarily on the covered bond model adopted in the jurisdictions. This calls for a certain level of flexibility in the transposition. In any case, the EBA wishes to remind that the notification to the EBA of breaches of the national law, as well as the publication of the sanction measures imposed (where applicable), are a requirement as per Article 24 of the CBD. In view of the above, the EBA has no further recommendation on this topic.

8. ASSET ENCUMBRANCE

KEY TAKEAWAYS OF THIS CHAPTER

ASSET ENCUMBRANCE

Covered bonds are an efficient instrument to transform illiquid assets into long-term liquid securities. Naturally, asset encumbrance is the direct consequence of the segregation of cover assets for the benefit of the secured investor. In practice, asset encumbrance is mainly regulated under the EU reporting framework, while the CBD is silent about the level and the possible consequences of encumbered assets. A financial system where a very high share of an institution's balance sheets is encumbered may pose threats in terms an of ability to raise sufficient liquidity by mobilising enough assets, and also in terms of the quality of assets in the hands of unsecured investors in case of default. For these reasons, most NCAs assess the level on asset encumbrance as part of credit institutions' contingent funding capacity under SREP. Very few Member States apply limits specific for covered bond-induced asset encumbrance.

The EBA thoroughly analysed the various national frameworks to find that asset encumbrance is rarely regulated at the covered bond level, but rather at the institution level. Limits are calculated in heterogeneous ways, from flat to risk weighted. Additionally, the EBA gathered quantitative information on the level of asset encumbrance in the EU (reported in the Chapter 15 of this report) only to **conclude** that the coverage of covered bonds contributes marginally to overall asset encumbrance. Consequently, **there is no ground for covered bond-specific recommendations in relation to asset encumbrance**.

8.1 Introduction

Asset encumbrance is directly interlinked with the segregation of a specific pool of typically high-quality assets (when having the balance sheet composition of a universal bank in mind) for a sub-set of the issuer's creditors (even more than they are owed in cases of 'European Covered Bond (Premium)' bonds). Being a framework dedicated to the protection provided by covered bond as a product, no CBD article makes explicit reference to it.

In financial regulation, asset encumbrance is primarily dealt with under the scope of reporting (Article 430(1)(1)(g) of the CRR) and disclosure (Article 443 of the CRR). In prudential supervision, asset encumbrance is one of many aspects of the assessment of an institution's ability to shield against dire funding conditions, which is intrinsically linked with the availability of marketable assets sufficiently acceptable as collateral to market participants.

Clearly, asset encumbrance is not exclusive to covered bond issuance, but it occurs in any kind of transaction where credit institutions provide collateral, most notably repurchase agreements, covered bond issuance, central bank funding and margining for derivative transactions.

8.2 The asset encumbrance frameworks in the EU

The NCA questionnaire revealed that only a very limited number of Member States provides for explicit covered bond-specific asset encumbrance limits. No asset encumbrance limits are applied to specialised mortgage credit institutions, which together with the universal bank model accounts for the bulk of covered bond issuance models in Europe. A thorough overview of the results can be found in Figure 19.

Figure 19: Overview of the different national legislation frameworks on asset encumbrance for covered bonds

Member State	Limit to CB-induced asset encumbrance / else: supervisory approach to AE	Mode of application and methodology of AE-limits on CB	Authority to impose AE limit (prudential or CB supervisor)	Limit objective (unsecured creditor protection / financial stability)	Article 7(2b) LCR-DR relevant
Austria	No / -	-	-	-	-
Belgium	Yes ([294])	Case-by-case	CB supervisor	Unsecured creditor protection	
Bulgaria	No / -	-	-	-	-
Cyprus	-	-	-	-	-
Czechia	No / -	-	-	-	-
Denmark	No / SMCI ([295])	-	-	-	-
Estonia	No / -	-	-	-	-
Finland	Yes	Issuer-specific / Risk-based ([296])	CB supervisor	Financial stability	-
France	No	-	-	-	Yes
Germany	No / -	-	-	-	-
Greece	Yes ([297])	Uniformly / Flat	CB supervisor	Unsecured creditor protection	-
Hungary	No / SMCI	-	-	-	-
Ireland	No / SREP / ILAAP	-	-	-	-

([294]) Since 2024 the NCA may issue a covered bond issuance limit based on two indicators: less than minimum MREL of 8% TLOF and breach of recovery plan limit for asset encumbrance as per published policy.

([295]) SMCI: specialised mortgage credit institution, typically limiting non-covered bond unsecured funding to intra-group funding.

([296]) Limit set in such a way that it does not reasonably jeopardise the refinancing of the business activities of a credit institution other than the mortgage banking activities. In assessing the risk to refinancing, multiple factors are considered.

([297]) Cover pool limited to 20% of available assets (excluding securitised assets, assets underlying reverse repos, and assets pledged to third parties); the NCA may grant a waiver.

Member State	Limit to CB-induced asset encumbrance / else: supervisory approach to AE	Mode of application and methodology of AE-limits on CB	Authority to impose AE limit (prudential or CB supervisor)	Limit objective (unsecured creditor protection / financial stability)	Article 7(2b) LCR-DR relevant
Italy	Yes ([298])	Internal limit / No methodology	CB supervisor	CB investor protection	-
Lithuania	No /–	-	-	-	-
Luxembourg	Yes ([299])	Uniformly to universal bank issuers / Flat	CB supervisor	Unsecured creditor protection	-
Netherlands	No / Overall AE limit	- ([300])	CB supervisor	Financial stability	-
Poland	No / -	-	-	-	-
Portugal	No / SREP/ILAAP	-	-	-	-
Romania	Yes	Uniformly / Risk-based ([301])	Prudential supervisor	Financial stability	-
Slovenia	No / -	-	-	-	-
Slovakia	No / -	-	-	-	-
Spain	No / SREP/ Resolution planning	-	-	-	-
Sweden	No / SREP / ILAAP	-	-	-	-

([298]) The issuer is required to internally specify the limit for segregation of assets to covered bond issuances, which will be assessed by the NCA in the covered bond permission process as well as on an ongoing basis for consistency with general risk assessment framework.

([299]) For universal bank issuers only, cover pool limited is limited to 20% of liabilities including own funds less DGS-protected deposits.

([300]) Institutions with an AE ratio below 10% will only be assessed if in resolution. If the ration is above 10% the bank must implement internal overall AE limit, monitored by the NCA quarterly.

([301]) Bucketing approach for four indicators: CET1-ratio (>20%, 16%-20%, <16%), NPL-ratio (<5%, 5%-8%, >8%), LCR (>300%, 150–300%, <150%), and loans/deposits-ratio (<80%, 80-100%, >100%); each bucket is associated with covered bonds-induced asset encumbrance limits of 20%, 15%, or 10%, applying a 'weakest link' approach.

8.3 Policy assessment

The treatment of the issue of asset encumbrance in financial regulation is typically twofold:

- From a supervisory perspective, the availability of unencumbered assets may enable a financial institution to raise necessary liquidity on a secured basis in times of impaired access to interbank or market liquidity (be it for idiosyncratic or systemic reasons). Thus, as a tendency, existing encumbrance of assets may be viewed as negatively affecting this ability.
- From a more general perspective, the issue is about the quality of assets to which unsecured creditors of an insolvent financial institution would have recourse to if the bulk of 'high quality assets' were to be made available to secured creditors, such as covered bonds creditors, on a priority basis. This may pose concerns on whether to apply the same risk weighting scheme to unsecured exposures vis-à-vis heavily encumbered credit institutions as opposed to those vis-à-vis moderately encumbered ones.

However, given the ability of the instrument to transform illiquid assets (long-term mortgage loans, loans to public sector borrowers) into long-term liquid securities, the EBA is of the opinion that covered bond-induced asset encumbrance shall not be regarded as an impediment to a credit institution's ability to raise liquidity in times of stress on a secured basis.

Aside from considerations on whether issuers can potentially bolster coverage for external covered bond rating stability in case of issuer or cover pool deterioration (something for which, in a very short time horizon, substitution assets as per Article 3(13) of the CBD can be useful), it would be inefficient to limit eligible assets for coverage purposes. In contrast, the ability for a non-covered bonds issuer credit institution to mobilise – efficiently – unencumbered assets of a typically cover-eligible type within a short time may be impaired more substantially, especially in a market-wide contraction in liquidity.

8.4 Conclusions

Due to the overall limited systemic extent of covered bond-induced asset encumbrance, the possibility to mobilise illiquid assets intrinsic in the architecture of covered bonds, and the varying propensity for asset encumbrance depending on the issuance model, the EBA is of the opinion that asset encumbrance levels induced by way of covered bond issuance does not warrant a product-specific limit. However, the EBA opinion shall not impede the legitimacy of establishing such limits at a Member States level.

9. THIRD COUNTRY EQUIVALENCE REGIME

KEY TAKEAWAYS OF THIS CHAPTER

OVERVIEW

Within EU legislation there is currently no framework regulating equivalence of third country covered bond systems. The COM has acknowledged the potential for establishing such an equivalence regime, which will need to consider several aspects. Some of these aspects include the possibility to grant third country covered bonds eligibility for preferential risk treatment under the CRR, the LCR and NSFR equivalence, and the possibility to access repo transactions.

Relevance

The EBA thoroughly analysed of the possible introduction of a third country equivalence regime. Potential benefits include expanding of the demand for European issuances and the opportunity to take the lead and establish a global market standard for the product. Possible drawbacks from the introduction of such a regime could be EU issuers facing increased competition from third countries and reputational concerns regarding of the quality of the product. Having carefully evaluated the pros and cons, **the EBA has concluded in favour of the establishment of such a regime**. This conclusion is also informed with market insight from the industry, who generally welcome this proposal for various reasons.

Prerequisites

The EBA identified essential requirements that shall be respected by the third country in order **to initiate the equivalence assessment process**. In particular, it is requested that:

Minimum provisions in terms of the **definition and regulatory treatment of credit institutions** and **of the concept of a dual-recourse, covered bond-like instrument** are guaranteed.

The **third country market is mature enough** to ensure equivalent effective protection of investments, in accordance with specific economic criteria to be assessed with regards to both current and foreseeable developments.

The **third country NCA offers reciprocity of treatment** as the overarching principle guiding the institutional relationships.

Scope

Pursuant to Article 31 of the CBD, which tasks **the EBA** to perform the analysis on the equivalence regime, the Authority **has identified in the CBD the scope of the assessment**. This means that **the third country regime shall be assessed against the relevant principles of the CBD,** as the minimum to be considered equivalent from the perspective of the EU covered bond framework. In addition to this, and depending on the level of ambition of the legislator, **the EBA also recommends a further alignment in terms of preferential risk treatment as per the CRR**, subject to stricter conditions like the provision of a list of potentially CRR-eligible covered bonds and a certified legal review of the contractual terms. Subject to these conditions, third country covered bonds may be granted the label of 'European Covered Bond (Premium)'.

Design and process

The EBA has also outlined a proposal for the actual process of equivalence assessment, which shall consist of an application to the COM upon the initiative of the third country NCA. This includes a self-assessment of the maturity of the home market and the degree of similarity of the regulatory and supervisory framework, as well as a declaration of intent to cooperate under the principle of reciprocity.

9.1 Introduction

With the ultimate goal of promoting EU covered bonds as a funding and investment tool in third countries, and attracting additional sources of funding for the EU, the EBA comprehensively assessed the merits of introducing a third country covered bond regime. This analysis includes an evaluation of the impact that it could have on EU markets, to provide a suitable design for such an assessment, and to determine the appropriate criteria and principles that should guide its determination. In particular, the analysis is structured, as follows:

- The first section elaborates on the relevance of establishing an equivalence regime, the industry feedback, and on the analysis of the pros and cons to establish such a regime.
- The second section elaborates on the design of the equivalence regime in terms of the prerequisites, scope, and process to follow.
- The third section discusses the principles to assess the equivalence with the CBD.

9.2 Relevance of an equivalence regime

An equivalence regime for third country covered bonds provides the basis for allowing their preferential treatment along three important dimensions:

- **Eligibility for preferential treatment** (preferential risk weight or preferential LGD) under the CRR: requires compliance with CBD for covered bonds issued after 8 July 2022 ([302]) and with the UCITS Directive for covered bonds issued before 8 July 2022. ([303]) As long as an equivalence regime has not been introduced (as clarified in an EBA Q&A), ([304]) EU credit institutions investing in third country covered bonds shall neither use the preferential RW treatment of 10% under the Standardised approach nor the favourable 11.25% Loss Given Default (LGD) for covered bonds under the internal rating based approach (Article 161 of the CRR). Instead, they shall use the 45% LGD for senior unsecured exposures. ([305])

([302]) For covered bonds issued after 8 July 2022 there is no such requirement. However, until an equivalence regime will be introduced for a covered bond to be eligible for preferential CRR treatment (Article 129 of the CRR) all the mandatory requirements of the covered bond directive should be met. In this respect, Article 3(1) of the CBD refers to covered bonds issued by a credit institution in accordance with the provisions of national law transposing the mandatory requirements of the CBD and that are secured by cover assets to which covered bond investors have direct recourse as preferred creditors.

([303]) For covered bonds issued before 8 July 2022 (deadline for member states to transpose and so apply the CBD) Article 52 (4) of the UCITS Directive refers to the fact that covered bonds must be issued by a credit institution with a registered office in an EEA Member State. Therefore, third country covered bonds are not eligible for the preferential treatment in Articles 129 and 161(1)(d) of the CRR.

([304]) See Q&A 2020_5522 Treatment of third country covered bonds under IRB Approach.

([305]) Nevertheless, EU credit institutions investing in UK covered bonds issued before the Brexit that met the requirements of the UCITS Directive and the CRR could continue using the preferential treatment until the bond's amortisation.

- **Eligibility for LCR (and NSFR) treatment**: In accordance with Article 11(1)(d)(ii) of the LCR Delegated Regulation, (306) third country covered bonds can be classified as Level 2A assets if – among other things – (307) (a) the issuer and covered bonds are subject by the national law of the third country to special public supervision, (308) and (b) they are subject to supervisory and regulatory arrangements at least equivalent to those applied in the EU. The EBA is of the view that, once an equivalence regime referred to in Article 31 of the CBD will be fully operational, its outcome with regard to a certain third country covered bond regime would inform whether the third country could be considered having equivalent supervisory and regulatory arrangements. This will substitute the current approach where an assessment is needed 'on a case-by-case basis' of the equivalence of the third country by the bank and its supervisor.
- **Eligibility for repo transactions with ECB**: as of today, the ECB seems to have quite a flexible approach. In accordance with Article 70 of the ECB Guideline (EU) 2015/510, (309) legislative covered bonds from G10 jurisdictions are in principle eligible for repo collateral, (310) subject to a case-by-case legal assessment regarding the protection of their rights. It may be expected that an equivalence assessment of the Commission for CBD purposes would affect this going forward.

9.2.1 MARKET OVERVIEW

The assessment of the relevance of introducing an equivalence regime in the EU should cover the impact that such a hypothetical regime could have on EU markets. In this respect, it is important to assess to what extent EU credit institutions hold covered bonds issued by credit institutions of third countries, and which ones, and to which extent credit institutions of third countries hold covered bonds issued by EU credit institutions.

Figure 20 and Figure 21 show the geographical composition of covered bonds that banks hold on the asset side and is taken from COREP template 9.1.a. Under this template, bonds as defined in Article 52(4) UCITS shall fulfil the requirements of Article 129(1) to (2) of the CRR to be classified in the exposure class 'Covered Bonds'. Nevertheless, bonds in accordance with Article 52(4) of the UCITS and issued before 31 December 2007, are also assigned to the exposure class 'Covered Bonds' following Article 129(6) of the CRR.

Interestingly, EU/EEA banks report that, as of December 2023, third country covered bonds represent 7.8% of the total covered bonds eligible for preferential risk weight treatment. The importance of third country covered bonds is heterogeneous across EU/EEA countries. Firstly, only 18 countries (out of the 25 countries that report covered bonds eligible for preferential risk weight) report third country covered bonds. Second, the dispersion among the 18 countries that report third country covered bonds is high, as the share of third country covered bonds ranges from 1.5% (Denmark) to 70% (Spain) of the total covered bonds eligible for preferential risk weighting.

The portfolio of third country covered bonds is big in countries that do not have the biggest portfolios of covered bonds eligible for preferential

(306) Commission Delegated Regulation (EU) 2015/61 of 10 October 2014 to supplement Regulation (EU) No 575/2013 of the European Parliament and the Council with regard to liquidity coverage requirement for Credit Institutions (OJ L 11, 17.1.2015, p. 1, ELI: http://data.europa.eu/eli/reg_del/2015/61/oj). as also emphasised by the EBA Q&A 2016_2823 Third countries considered to have supervisory arrangements equivalent to EU.

(307) Other conditions concern restrictions on cover assets (exposures to third country central governments, loans secured by residential and commercial property, ship loans), meeting Article 129 of the CRR requirements for exposures to institutions in the cover pool; meeting the transparency requirement laid down in Article 14 of the CBD; being at least credit quality step 1 and having an over-collateralisation of 7% (2% is fine if issue size is at least 500 million).

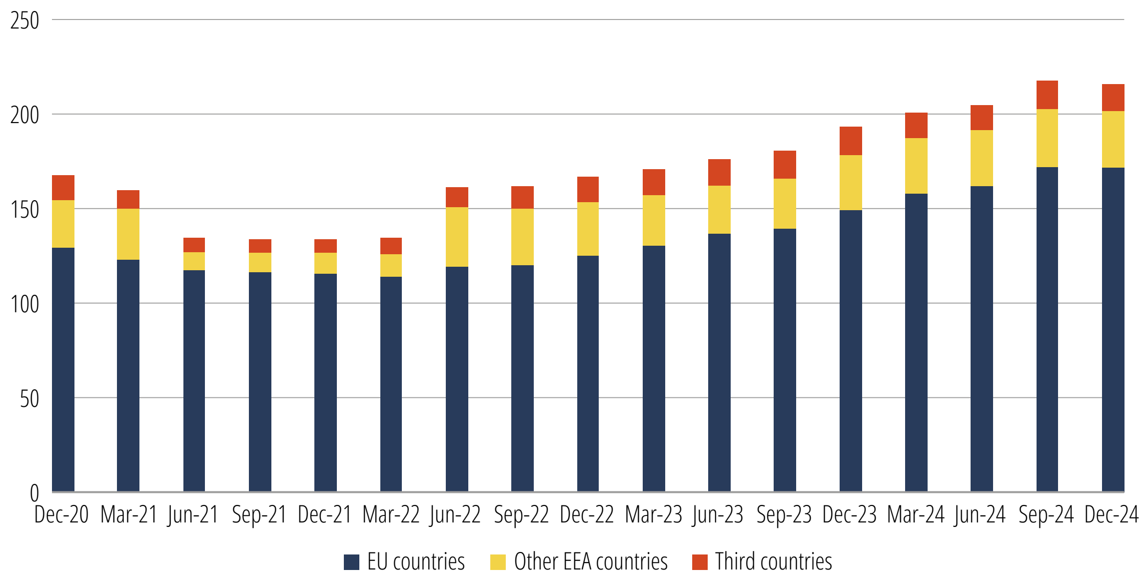
(308) For EU covered bond it is requested to respect the definition of covered bonds in Article 3(1) of the LCR Directive 'issued by a credit institution in accordance with the provisions of national law transposing the mandatory requirements of this Directive' which implies to be a 'EU covered bond' under the CBD.

(309) Guideline (EU) 2015/510 of the European Central Bank of 19 December 2014 on the implementation of the Eurosystem monetary policy framework (OJ L 91, 2.4.2015, p. 3, ELI: http://data.europa.eu/eli/guideline/2015/510/oj).

(310) Some exceptions being complex instruments like covered bonds backed by ABS.

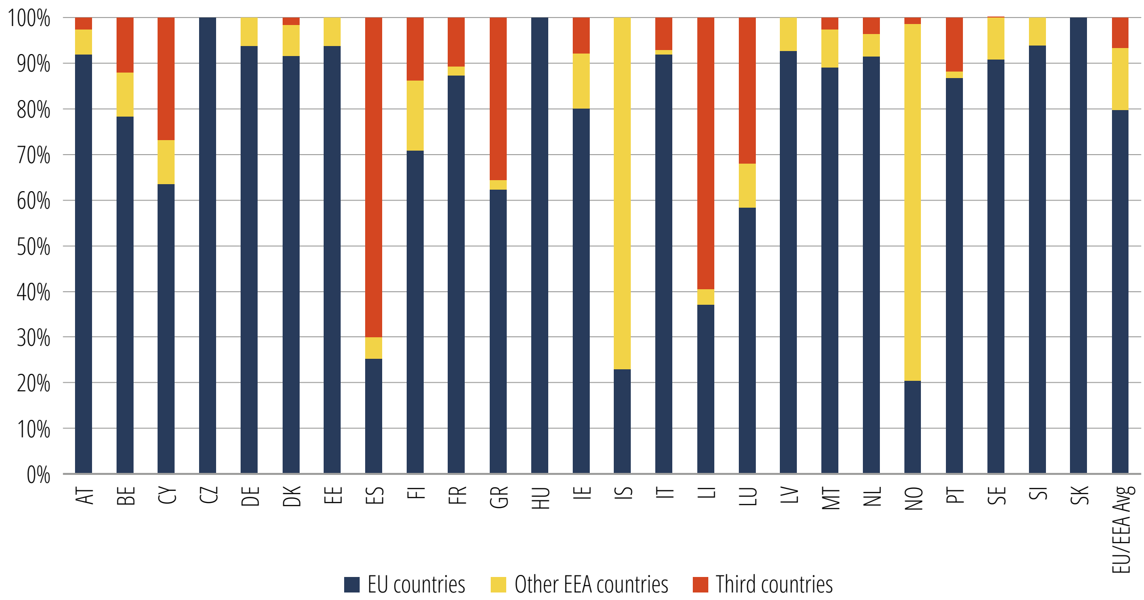
risk weight. This is the case in Spain, Luxembourg and Liechtenstein. On the contrary, countries with bigger portfolios of covered bonds eligible for preferential risk weights (Germany, Denmark, and Norway) are among those with small portfolios of third country covered bonds.

Figure 20: Outstanding amount of covered bonds subject to preferential risk weight treatment by jurisdiction of the counterparty, Q4 2020 to Q4 2024, billion euro



Source: COREP and EBA calculations.

Figure 21: Share of outstanding amounts of covered bonds subject to the preferential risk weight treatment, breakdown by jurisdiction of the counterparty, December 2024, percentage

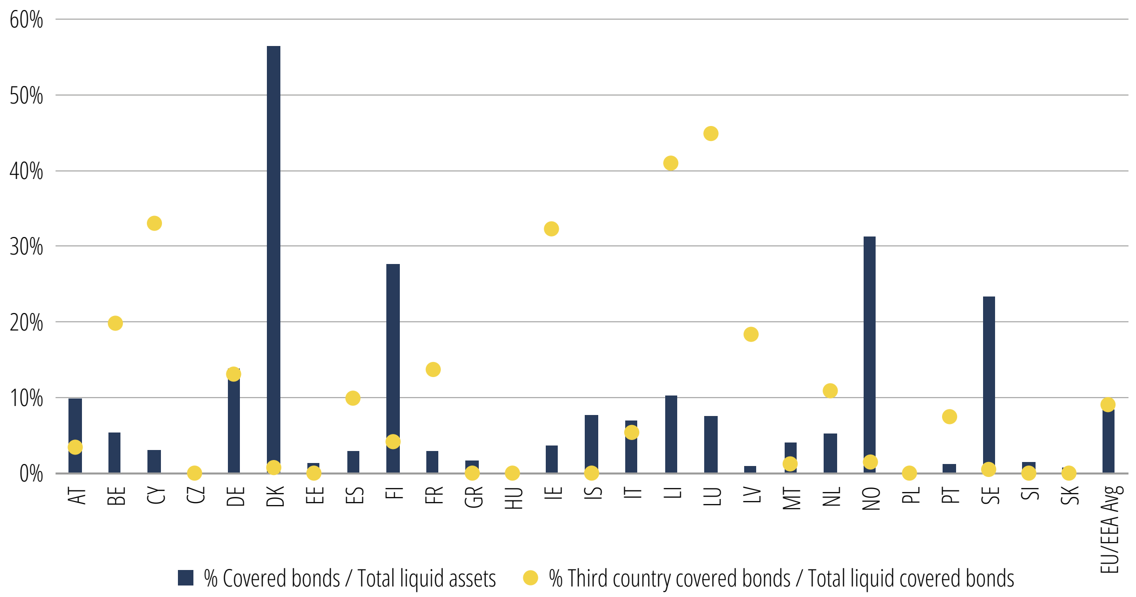


Source: COREP and EBA calculations.

Figure 22 and Figure 23 show the relative importance of third country covered bonds included in the HQLA as of December 2024 (data from C.72.00 template). For what concerns the performance of significant third country covered bond markets, including Brazil, Canada, and

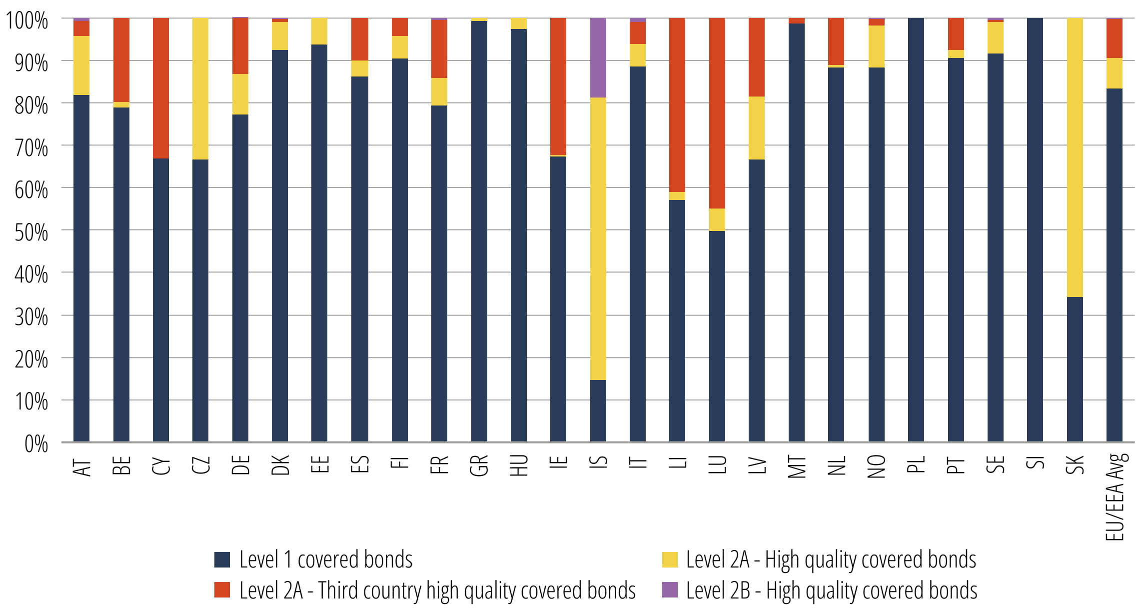
Singapore, the EBA points out that data availability currently does not allow a thorough assessment. However, the EBA invites readers to refer to the ECBC for further information. ([311])

Figure 22: Liquid bonds over the stock of liquid assets and share of liquid third country covered bonds over total liquid covered bonds, December 2024, percentage



Source: COREP and EBA calculations.

Figure 23: Covered bonds that qualify for high quality covered bonds, breakdown by level under LCR framework and by country, December 2024, percentage



Source: COREP and EBA calculations.

([311]) ECBC Global concept note on third country equivalence for covered bonds.

9.2.2 FEEDBACK FROM THE INDUSTRY

Market participants would welcome the establishment of a third country equivalence regime. Such a regime is expected to push further EU and global covered bonds harmonisation, integration of covered bonds markets, and their regulatory treatment.

Issuers would welcome the possibility to broaden their investor base and attract new funding, as at present extra-EU investment in EU covered bonds is limited (as confirmed by market analysts). Generally speaking, banks from southern EU countries (especially in Italy and – to a lesser extent – in Greece and in Spain) claim to have an excess supply (or that they would be willing to expand further their supply), while issuers based in northern EU countries tend to agree that EU investors are currently enough to cover the supply in their markets. For this reason, the establishment of the regime may benefit southern issuers via an overall increase in demand coming from an expansion of the investors' base from the rest of the world. There is a wide consensus that the equivalence regime shall be designed to avoid an unlevel playing field and confusion among investors derived from covered bond mislabelling.

The wide sentiment among issuers is that ad-hoc agreements should be avoided in favour of the establishment of universal minimum requirements (minimum over-collateralisation, a restriction of the framework to credit institutions, a level of transparency, dual recourse, etc.).

Even with a level-playing field, there is concern among issuers regarding an increase in competition, which is perceived to be detrimental to domestic demand. In times of low demand increased competition can result in higher funding costs. The EBA concluded that effects on competition shall in any case be included in analysing the pros and cons of the establishment of the regime.

Interestingly, investors declared that exposures in third countries constitute already a significant portion of their asset portfolios (about 30%, similar across respondents), and may even grow with Basel now being adopted in many third countries. Also, the share of non-euro area issuance has increased steadily as new jurisdictions emerged. Most of the investment is in well-established and active markets, such as Australia and Canada. ([312]) In comparison, the opposite is by far lower, with most respondents indicating percentages in the range of 0% to 5% of sales outside the EU, mostly in the UK. Analysts affirm that, in addition to the limited knowledge that investors from third countries have of the EU market, other obstacles to foreign investment exist. These obstacles can be attributed to higher risk appetites than EU covered bonds can satisfy, the lack of interest in euro-denominated instruments, but most importantly the fact that the European investor base is – at present – so big that there is little room for allocation on the global market.

As to the other factors that affect investment decisions, some are equally valid for the EU market (i.e. the evaluation of cover pool composition (with a preference for residential mortgages), the level of over-collateralisation, spreads with respect to instruments with a similar risk profile, and investor protection). Others are more specific, like the liquidity and the depth of the third country market, the availability of products with different maturity structures (especially shorter, whilst the EU market is tilted towards medium-long maturities), and of course, robustness of the foreign legal framework.

Some investors consider investment diversification the main benefit of investing in third countries, and indeed they agree that an equivalence regime would further help diversification. This benefit alone may outweigh the associated risks that may stem from the uncertainties that can come with a new equivalence regime. Global financial integration and liquidity enhancement are also viewed as important benefits. In this perspective, in the short term an equivalence assessment will have the beneficial result of facilitating the diversification strategies and increasing their competitiveness. It should do this whilst affirming the EU legislative framework as a global benchmark.

([312]) On the other hand, market specialists affirm that many other third countries are asking guidance to provide a legislation package which is in line with the EU framework and can therefore attract EU investors.

In detail, diversification does not only involve cover pool granularity or a geographical dimension. Market participants saw the average maturity of EU covered bond increase significantly over the past year (at present, most issuances are between 7 and 10-years' maturity). The availability of short maturities is welcomed by investors, which affirm that many third countries have already a deep market specialised in short-term covered bonds. An important point raised by analysts and rating agencies is that an equivalence regime would also bring more diversification to a banks' treasury management, drifting them away from the heavy reliance on domestic sovereign bonds.

Investors (mostly credit institutions) also advocate the same favourable capital and liquidity treatment to be applicable to third country covered bonds that is currently applied to the EU covered bonds in the market. In detail, third country covered bonds should have access to the same LCR treatment (upgraded from Level 2A to Level 1) and the same RW treatment (as low as 10% for those with high ratings) as EU issued covered bonds. Repo eligibility is also a major driver of investment in third country covered bonds. ([313]) An important obstacle in investing in third countries would still be constituted by foreign currency denomination, in that it limits the liquidity of foreign-denominated covered bonds within the EU market. Few are concerned about the credit quality of (mature) third country covered bonds, but rather about the reliability of the local supervisory framework and their strict EU regulatory treatment. After all, analysts and rating agencies confirm that – in the countries they monitor – credit quality assigned to covered bonds is in general comparable to that of European products, and so is the credit protection.

9.2.3 PROS AND CONS OF AN EQUIVALENCE REGIME

Having considered all aspects involved in the proposal for a third country framework, the EBA concluded that the elements supporting the establishment of an equivalence regime are:

- **Short-term benefits**: facilitating EU issuers and investors diversification of their funding/ investment strategies and exporting the EU framework/principle-based approach to third countries, thus strengthening the concept of covered bonds more broadly.
- **Medium-to-long term benefits**: the implementation of a third country covered bond legislation, and the introduction of a preferential treatment (for solvency and/or liquidity requirements) may incentivise the creation of a domestic third country covered bond investor base. This would contribute to enhancing further liquidity for EU covered bonds and constitute an additional source of the funding of EU credit institutions.

In addition, the imminent introduction of a preferential risk weighting at a global level following the adoption of Basel III calls for taking advantage of the favourable momentum and justifies the introduction of an equivalence regime to avoid an unlevel playing field.

However, an equivalence regime comes with costs and risks:

- The development of a third country equivalent regime may increase competition for EU covered bonds. The equivalence regime and assessment should however ensure a level playing field and assure the same regulatory and supervisory standards for the EU and third country covered bonds.
- Reputational concerns may arise in cases of default of a covered bond in a third country assessed as 'equivalent', with possible spillover effects into the EU market.
- Lastly, initial costs in terms of resources needed for the actual implementation of the equivalence regime may be burdensome.

9.2.4 CONCLUSIONS

The EBA is of the opinion that the development of an equivalence regime is desirable to (a) support risk diversification for issuers and investors, and (b) as a means to export the EU covered bonds principles and practices.

([313]) Currently, only Canada fulfils the requirements.

Looking at the potential disadvantages, the COM is invited to consider the principle of reciprocity (including domestic preferential treatment of EU covered bonds) in the assessment, to mitigate competition concerns, as this may incentivise the creation of a third country domestic investor base, which could ultimately increase the liquidity of the EU covered bond markets. Finally, to reduce concerns regarding reputational risks and a potential unlevel playing field, the regime shall be, while flexible, robust enough to ensure that the key principles embedded in the EU framework are strictly respected.

Recommendation 15. *On the relevance of establishing a third country equivalence regime.*

Having considered the pros and cons, and in view of the current policy momentum that followed the introduction of a preferential risk weighting at a global level in the Basel Accord, the EBA is of the opinion that there is a relevant case to in develop a third country equivalence regime.

9.3 Prerequisites, scope and design of the equivalence assessment

There are three main dimensions related to the design of a third country equivalence assessment:

- the prerequisites for triggering the equivalence assessment, which include:
  - the essential requirements for issuing covered bonds;
  - the maturity of the third country covered bonds market;
  - the cooperation of the third country supervisory authority coupled with a principle of reciprocity;
- the scope for the equivalence assessment, which entails the essential CBD principles and a clarification on how compliance with Article 129 of the CRR could be achieved;
- the practical steps of the process to be followed for the establishment of the regime.

9.3.1 PREREQUISITES FOR TRIGGERING THE EQUIVALENCE ASSESSMENT

Firstly, the design of the equivalence regime shall lay down the very fundamental requirements which are propaedeutic to the initiation of the assessment. Lacking these requirements, the process cannot be triggered, meaning the application cannot be filed. Figure 24 reports such fundamental requirements (which are CBD-related and of a more general nature) and give the corresponding CBD reference, together with its Basel equivalent. Such prerequisites entail a similar definition of what is a credit institution, the very basic features that a covered bond should have (e.g. the preferred status given to investors via asset segregation), and the application by the third country of prudential supervisory and regulatory requirements to credit institutions at least equivalent to those applied in the Union as referred to in Article 107(4) of the CRR. (314) Only in this case, an exposure towards a third country

(314) A list of third countries that are deemed equivalent for these purposes can be found in Annex I of the Commission Implementing Decision (EU) 2021/1753 of 1 October 2021 on the equivalence of the supervisory and regulatory requirements of certain third countries and territories for the purposes of the treatment of exposures in accordance with Regulation (EU) No 575/2013 of the European Parliament and of the Council (OJ L 349, 4.10.2021, p. 31, ELI: http://data.europa.eu/eli/dec_impl/2021/1753/oj).

bank shall be treated as exposures to a credit institution for the purpose of credit risk and, therefore, only in this case the CBD requirement set forth in Article 2 of the CRR that the covered bond is issued by a credit institution would be met, i.e. the first line of recourse towards the bank could be considered as valid for the purpose of the covered bonds.

Secondly, the EBA acknowledges the risk that third countries may be tempted to adopt legislation like the one established in the EU for the sole purpose of entering the EU market without an actual potential for expansion of EU issuers into the third country domestic market. To avoid a blind adoption of the EU rules, and to ensure that the equivalence assessment may bring also new investors in the EU covered bond market, it is proposed to make the equivalence assessment conditional on a certain level of maturity of the third country domestic covered bond market. This maturity assessment considers the volumes and relative importance of investments in covered bonds by the domestic financial sector as well as the support that domestic covered bonds receive (e.g. acceptance and potentially actual use of covered bonds for central bank monetary policy operations vis-à-vis unsecured debt). ([315]) The said criteria should be assessed before granting equivalence, so that the market will be considered mature from that point in time onwards.

([315]) As such, the assessment will not entail granular information.

Recommendation 16. *On the maturity of the domestic covered bond market.*

The EBA recommends that an assessment of the maturity of the third country domestic markets shall constitute a condition to initiate the equivalence assessment. Examples of criteria to be considered as part of the overall assessment are the following:

- *The relevance of the share of domestic investors in the domestic covered bond market (excluding retained covered bonds).*
- *The share of euro denominated bonds versus those in domestic currency to assess whether the issuance is conceived primarily for the EU market.*
- *The eligibility and the utilisation of domestic covered bonds for repo operations and the presence of a favourable prudential treatment within the third country, on the ground that this is likely to imply a stronger supervision of the third country NCA.*
- *The dynamics of the domestic market, on the ground that the third country market – albeit not sizeable at the moment of the analysis – may have expanded in recent time, and it is projected to continue growing.*

Thirdly, the cooperation with the third country supervisory authority and the recognition of reciprocity shall also serve as an overarching principle to establish the regime. Reciprocity shall ensure that equivalent third country covered bonds are treated as domestic (EU) covered bonds. This implies also that neither of the two parts (EU nor third country) can be expected to ask the respective NCA counterparty for a better treatment of their own covered bonds than the one that is applied to domestic covered bonds (e.g. asking for a preferential risk weight treatment, if there is not one, or more lenient eligibility criteria). However, it should be noted that this concept of reciprocity is not envisaged in other equivalence assessments, such as the equivalence as referred to in Article 107(4) of the CRR.

Figure 24: Essential requirements for the equivalence assessment

Principles for European CB label	Article (CBD)	Article (Basel)	Description
Requirements for issuing CB			
Nature of the issuer	2	CRE20.33	The issuer is a credit institution established in the applicant country, i.e. an entity the business activities of which include the kind mentioned in Article 4(1)(1) of the CRR (316) and is subject to prudential supervision as well as to supervision for compliance with mandatory covered bond law. The requirement implies equivalence of treatment of unsecured exposures as per Article 119 of the CRR, (317) and it is assessed against the COM Implementing Decision on the equivalence of the supervisory and regulatory requirements of certain third countries and territories for the purposes of the treatment of exposures in accordance with the CCR. (318) The issuer is supervised by a foreign authority whose confidentiality and professional secrecy regime has been deemed equivalent. (319)
Fundamental definition of covered bond	3(1)	CRE20.33	The instrument is a debt obligation that is issued by a credit institution and secured by cover assets to which covered bond investors have direct recourse as preferred creditors in accordance with the applicable insolvency law.

9.3.2 SCOPE OF THE EQUIVALENCE ASSESSMENT

In terms of the scope of the assessment, the EBA recommends it to be based on the principles outlined in the CBD.

(316) As reported also in Article 7(1) of the CBD.

(317) Excluding large investment firms.

(318) Commission Implementing Decision (EU) 2021/1753 of 1 October 2021 on the equivalence of the supervisory and regulatory requirements of certain third countries and territories for the purposes of the treatment of exposures in accordance with Regulation (EU) No 575/2013 of the European Parliament and of the Council (OJ L 349, 4.10.2021, p. 31, ELI: http://data.europa.eu/eli/dec_impl/2021/1753/oj).

(319) The rules governing such equivalence are laid down in the EBA Guidelines on the equivalence of confidentiality and professional secrecy regimes of third-country authorities (EBA/GL/2022/04).

Recommendation 17. *On the scope of the equivalence assessment.*

The EBA recommends designing a regime that has the CBD as its scope and main pillar, as prescribed by Article 31 of the CBD. The purpose of the assessment – which shall be performed in accordance with the rules laid down in the EBA Founding Regulation (320) – shall be to check that the relevant principles provided for in the CBD are in force in the third country legislation.

(320) Article 33(2) of 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, ELI: http://data.europa.eu/eli/reg/2010/1093/oj) (International relations including equivalence), in accordance with which the EBA shall assist the Commission in preparing equivalence decisions. .

The equivalence would grant third country covered bonds the possibility to be treated as European covered bonds. The additional step of granting third country covered bonds the preferential risk treatment applied to 'European Covered Bond (Premium)' bonds would require a procedure to check for equivalence with the EU prudential risk treatment under Article 129 of the CRR.

For these purposes two alternative ways could be considered. If the third country already has in place a preferential risk weight treatment for covered bonds, the third country authority could request to perform an assessment also of the equivalence of domestic prudential treatment provisions with Article 129 of the CRR. In case of a positive outcome, and conditional on an agreement with the third country NCA to compile a list of 'European Covered Bond (Premium)' covered bonds (i.e. eligible for the domestic preferential equivalent treatment), third country covered bonds shall be automatically considered as CRR equivalent without further requirements on the investor side.

In the absence of a list of third country covered bonds coupled with a compliance assessment from the COM, Article 129 of the CRR requirements could be still checked contractually, as long as they are objectively defined. In this regard, the EBA is of the view that investors' due diligence shall include a legal review confirming the compliance with Article 129 of the CRR requirements. This legal review shall be provided by a law firm, which has expertise in the EU market. It shall serve the purpose of helping EU supervisors in their monitoring process.

Recommendation 18. *On the compliance with Article 129 of the CRR.*

The compliance of the third country regime with Article 129 of the CRR shall be ensured via a confirmed equivalence of the framework with CRR requirements performed by the EBA and validated by the COM, coupled with either a list of domestic eligible 'premium-like' covered bonds provided by the third country authority, or checked contractually and confirmed by a review provided by a certified legal firm upon request of the investor.

9.3.3 DESIGN AND PROCESS OF THE EQUIVALENCE ASSESSMENT

In terms of practical steps for the initiation of the process, the equivalence assessment shall be started by means of a qualified application from the third country authority, ([321]) whose design should ensure that:

- Assessment proceedings shall be performed in English. Applicants shall provide English translations of all relevant legal references, as well as references to the original legal references in the public domain.
- No assessment proceeding shall be initiated solely on grounds of issuers established in the EU/EEA wanting to benefit from their covered bonds from reciprocal preferential treatment in a third country.

([321]) The Sponsorship should be given by three entities (if separated):
([1]) The public authority tasked with supervision of issuers' compliance with covered bond law.
([2]) The public authority tasked with prudential supervision of financial institutions.
([3]) The public authority tasked with monetary function (central bank).
Each duly authorised to enter into Memoranda of Understanding of granting reciprocal preferential treatment, if any, to investments by the applicant country's financial institutions into qualifying covered bond issued by credit institutions established in the EU/EEA without regard to the issuer's establishment or authorisation outside the applicant country.

Recommendation 19. *On the components of the application for an equivalence assessment.*

The EBA recommends that the third country equivalence assessment shall be triggered by the submission of an application from the third country authority. This application should include:

- *A self-assessment of the third country authority confirming the maturity of the domestic covered bond market. This assessment shall be based on (and include relevant information to assess) the non-exhaustive criteria discussed in Recommendation 16. The information provided shall allow a holistic assessment of the maturity of the third country market.*
- *A confirmation of the intention of the third country to cooperate with the EU NCAs, and to adhere to the principle of reciprocity, i.e. ensuring that EU-equivalent covered bonds are treated as domestic covered bonds.*
- *The evidence that the third country applies prudential supervisory and regulatory requirements at least equivalent to those applied in the Union as requested in Article 107(3) and (4) of the CRR.*
- *A commitment of the third country authority to compile a list of covered bonds that are issued in line with their legislation as per Article 26 of the CBD.*

9.4 Principles for the equivalence assessment

The EBA suggests that the technical specifications to assess a third country covered bond model shall be applied following a principle-based approach. The choice is motivated primarily by the existence of different cover bonds models within the EU and a high number of national discretions existing in the current text of the CBD, but also by the need to encompass the diverse covered bond models in third countries. In fact, it will be challenging to strike the right balance between the safety features of product components and the necessary flexibility for third countries and their market traditions, as it has been done at the time of the covered bond legislative package at the EU level. A more rigid approach would make impossible any assessment, as not only prudential regulation, but also civil, mercantile and insolvency national regulations affect this product.

In addition, the EBA suggests – to guide the principle-based assessment – to also have a comprehensive view of current market practices in the third country. Given that issuers often meet the requirements on a contractual level, market practices could very well complement the analysis by giving insight on the way regulations are applied.

Considering the scope of the equivalence assessment, the principles shall follow the provisions of the CBD. Of course, it is important to flag that the same 'dual spirit' of the Directive shall apply. Namely, the fact that some of the said provisions are compulsory, while others contain options to be used at the discretion of the national legislators in order to provide the necessary flexibility to account for the different models of covered bonds in the country (with minimum requirements to be respected).

Figure 25 presents the list of principles to be assessed and is grouped by the three areas of ruling concerning investor protection in which the CBD is organised:

- structural features of covered bonds;
- covered bond public supervision;
- publication requirements in relation to covered bonds.

Figure 25: List of principles for the assessment of the equivalence regime

Principles for European CB label	CBD Article	Basel Article	Description
Structural features of CB			
Dual recourse	4(1)-(2) ([322])	CRE20.33	Covered bonds issued in accordance with the applicant country's covered bond law constitute unconditional payment obligations of the issuer (first layer of recourse), secured on a defined pool of assets (cover assets) in case of issuer insolvency or involuntary resolution (second layer of recourse), with the covered bond creditors and counterparties of segregated derivative contracts participating as unsecured creditors at least *pari passu* with other unsecured creditors in the general insolvency proceedings over the issuer's general estate to the extent, claims of these covered bond creditors remain unpaid after execution of their security right over the segregated assets (third layer of recourse).
'Bankruptcy remoteness'	3(9)		The legal process for the settlement of claims of covered bond creditors, including counterparties of segregated derivative contracts, upon insolvency of the covered bond issuer does not provide for covered bond creditors to enforce their priority claim over assets in the cover pool individually.
Eligible cover assets	6, 7, 11	CRE20.34	The CB legal framework shall allow for all assets declared eligible under Article 6 of the CBD. Additional requirements shall be met: ▪ in case of cover assets in form of a derivative contract, the counterparty of the covered bond estate needs to be unilaterally obliged to provide variation margins; ([323]) ▪ in case of utilisation of non-domestic cover assets, the issuer shall be required to ensure the preferential claim of covered bond creditors over such cover assets in case of issuer insolvency (e.g. by establishing insolvency-proof trusts holding the non-domestic cover assets for the benefit of the issuer's covered bond estate); ▪ in case of utilisation of cover assets under Article 6(1)(b) of the CBD, the additional requirements set forth in Article 6(3) of the CBD shall be introduced in a similar manner (for instance, EU and third country public registries for physical assets shall be comparable), together with a definition of HQLA compatible with EU standards.
Composition of the cover pool	6(8), 10	CRE20.35	The CB law should require composition of the pool of cover assets in a manner so as to limit risk concentrations with regard to obligors, collateral assets, sectors (e.g. by types of utilisation of collateral assets). Flexibility in the provisions ruling the details of the composition should be given, provided they are fully disclosed for the investor to properly assess the type of covered bond and the relative risks.

([322]) Paragraph 3 shall not be excluded from the principled for lack of relevance in relation to the equivalence assessment.

([323]) As effected by Article 30 of the Commission Delegated Regulation (EU) 2016/2251 of 4 October 2016 supplementing Regulation (EU) No 648/2012 of the European Parliament and of the Council on OTC derivatives, central counterparties and trade repositories with regard to regulatory technical standards for risk-mitigation techniques for OTC derivative contracts not cleared by a central counterparty (OJ L 340, 15.12.2016, p. 9, ELI: http://data.europa.eu/eli/reg_del/2016/2251/oj).

Principles for European CB label	CBD Article	Basel Article	Description
Segregation of cover assets	12		The cover assets, and any secondary claims attached to the cover assets (e.g. claims from insurance of collateral property against risk of damage) are segregated from the issuer's general/insolvency estate in a manner that puts the pool of cover assets beyond the legal reach of non-covered bond creditors, including the risk of set-off, and this effect is recognised by general insolvency law applicable to the issuer.
Cover pool monitor	13		The compliance with the requirements for the manner of segregation as well as sufficient eligible assets being segregated to comply with statutory or contractual coverage requirements is monitored – in a timely fashion – by a qualified external party independent from the issuer and free of any potential conflict of interest; de-segregation by issuer action without that external party's consent is to be rendered legally void (meaning the covered bond creditors' preferential claim would extend to any asset de-segregated without required consent for as long as it is still an asset of the issuer).
Coverage requirements	15	CRE20.30 CRE20.35	The issuer is required to segregate at all times eligible assets in an amount sufficient to cover all liabilities attached to the covered bonds and derivative contracts segregated (including conditional obligations for repayment of (cash) collateral received under the contracts governing the derivatives) by claims attached to the cover assets, including those necessary to comply with requirements of minimum statutory or contractually committed over-collateralisation. The methodology applicable for calculation of sufficient coverage, especially of non-principal related payment obligations or, if any, by non-principal related payment claims attached to the cover assets, is to be specified by law or publicly accessible supervisory practice.
Cover pool liquidity buffer	16		Where the method of exercising the covered bond creditors' security right (second layer of recourse) comprises an orderly wind-down in accordance with the covered bonds' payment schedule as provided for by their terms and conditions, the issuer shall be subject to an ongoing liquidity coverage requirement that would immunise the covered bond estate subsequent to issuer insolvency to have to resort to liquidating illiquid cover assets for meeting payment obligations, for a period of time after issuer insolvency deemed sufficient by the legislators or supervisory authority, for the covered bond estate to establish a viable mode of managing cash flow gaps by way of liquidating illiquid cover assets. Any liquid assets required for meeting such requirement shall be segregated.
Conditions for extendable maturities	17		If maturity extensions are permissible, the conditions for extension shall be specified in covered bond law. Any scheme – by law or contract – allowing maturity extension to occur shall meet the requirements of Article 17(1) of the CBD.
CB public supervision			
CB public supervision (ongoing and in the event of insolvency or resolution)	18, 20	CRE20.33	A public authority of the issuer's country of establishment shall be tasked by law with supervision of issuers' compliance with mandatory covered bond law.
Powers of competent authorities for the purposes of CB public supervision	22		The public authority shall be vested with the powers necessary to perform covered bond supervision (investigative/exploratory powers, powers to enforce and to sanction breaches of mandatory covered bond law).

Principles for European CB label	CBD Article	Basel Article	Description
Disclosure requirements for competent authorities	26		The public authority shall publish at least annually a list of issuers entitled to issue covered bonds and of covered bonds issued in accordance with covered bond law; the list of covered bonds shall specifically indicate those identifiable covered bonds complying with the standards established in CRE20.33.
Publication requirements in relation to CB			
Investor information	14	CRE20.37	The issuer shall be required to regularly disclose information of the composition of the cover pool, the level of coverage, as well as the exposure to market, credit, and, where relevant, liquidity risk, in sufficient detail so as to enable investors to perform risk assessments adequate to their level of exposure.

10. EUROPEAN SECURED NOTES ('ESNS')

KEY TAKEAWAYS OF THIS CHAPTER

EUROPEAN SECURED NOTES (ESNS)

The introduction of a dual recourse-like instrument targeted to SMEs has been extensively debated in the past year and has also been under study of the EBA in 2018. Allowing for commercial loans to be eligible as assets covering such an instrument would undoubtedly have the merit of increasing the possibility for issuers to secure a relatively cheaper source of funding to foster SME financing. At the same time, concerns about the quality and the resilience of such an instrument (and the subsequent reputational spillovers to an already well-functioning covered bond market) has made both the legislator and part of the industry cautious about such an innovation at this time.

The EBA also acknowledges the presence of a 'vicious circle' in which the legislator is waiting for market interest whilst market participants are waiting first for regulatory initiative. At the same time, **the EBA** wishes to remind readers of the recent outcome of the COM consultation with the industry, in accordance with which other structured finance instruments (like securitisation) have been deemed inappropriate for SMEs financing due to their intrinsic complexity. This result may **advocate for a reopening of the debate in the medium term, to which** the EBA **gives availability for a technical analysis**.

10.1 Introduction

Since the 2018 EBA Report answering the European Commission's Call for Advice on European Secured Notes (ESN), EU policymakers and industry representatives have renewed their interest around the case for developing a dual recourse-like instrument targeted to SME lending as one important building block towards the SIU. [324] According to the data shown in Figure 26, SMEs play a significant role in the EU economy, amounting for 99.8% of the enterprises, two third of the employees, and more than half of the value added (figures below refer to Europe as a whole).

[324] See the European Secured Notes (ESNs) Blueprint, ESN task force, ECBC, July 2024.

Figure 26: Summary statistics of the SMEs sector in Europe, 2023

Class size	Number of enterprises		Number of employees		Value added	
	Number (M)	Share	Number (M)	Share	Euro (bn)	Share
Micro	22 744	93.5%	38 790	29.4%	1 420	18.6%
Small	1 332	5.5%	25 602	19.4%	1 260	16.5%
Medium	205	0.8%	20 494	15.5%	1 267	16.6%
Total SMEs	21 281	99.8%	84 886	64.4%	3 946	51.8%
Large	43	0.2%	46 919	35.6%	3 674	48.2%
Total	24 324	100%	131 805	100%	7,920	100%

Source: ECBC and EBA calculations.

10.2 Previous assessment: the 2018 EBA Report on ESNs

In October 2017, the European Commission sent the EBA a Call for Advice on the case for developing European Secured Notes (ESNs), with the purpose of: (i) assessing whether a covered bond-like dual recourse instrument may provide a useful funding alternative to banks engaged in lending to SMEs (and also to infrastructure projects), and (ii) determining an appropriate EU framework and regulatory treatment.

The response to the CfA includes the outcome of the assessment recommendations to design the legislative framework for ESNs. (325) The summary of the outcome is the following:

- ESNs may become a useful financing tool for small institutions in time of crisis, given the overall difficulty in securing funding via access to the securitisation market or issuance of traditional unsecured debt.
- As of now, the interest by potential investors is uncertain, especially in relation to the risk-return profile and regulatory treatment (above all, LCR provision and EBA collateral eligibility). The EBA acknowledges the presence of a 'vicious circle' where lack of political and regulatory impulse reduces investor interest, which in turn determines little motivation for policy action.
- Estimating the potential size of an ESNs market is not straightforward given the high number of factors at play, namely the existing funding mix available to institutions, the monetary policy stance, the MREL needs, the business cycle, the availability of assets, the premium with respect to other instruments such as traditional covered bonds, and regulatory and monetary policy collateral treatment. If assuming the potential coverage as being equivalent to that of residential mortgages for covered bonds, the report estimated a market size within a range of 300 to 900 billion euro (against a current market size of covered bonds of about 2.5 trillion euro in the EU).
- The EBA report warned that given the generally higher risk and heterogeneity of SMEs loans compared to RRE mortgages (but also to other corporate exposures), over-collateralisation is expected to grow as a result of the introduction of ESNs, and as a consequence also the overall levels of assets encumbrance.
- Indeed, the major source of concern in terms of asset performance is the high degree of heterogeneity, together with a higher pro-cyclicality given the intrinsic link of SME production with the overall business cycle.

(325) See the EBA Final report on ESNs.

To overcome the issue, the Report suggested stricter eligibility criteria at both loan and pool level in terms of selection of exposures, degree of granularity, limits to concentration, quality standards, minimum over-collateralisation levels, and scope of disclosure requirements.

- In terms of regulatory treatment, the EBA concluded that – whilst there may be the possibility to grant some preferential treatment with respect to unsecured exposures – requirements would also have to be stricter than those applied to traditional covered bonds, in addition of a fully-fledged dual recourse feature. To avoid market confusion and negative spillover to a well-established covered bond market, under no circumstances the prudential treatment shall be aligned between the two instruments.
- To resume, the Report envisaged an instrument that would position itself 'in between' covered bonds and unsecured exposures in terms of regulatory treatment. The overall assessment is cautious over the convenience of such an instrument. While the benefits of ESNs are fully acknowledged at a macroeconomic level, uncertainty remains on the appropriate framework to be applied, especially in relation to the eligibility of cover collateral and minimum collateralisation levels. The crucial point is ultimately whether the risk-return profile of such a product will be attractive enough to compensate for the stricter regulatory framework, and consequently to develop a solid investor base on one side, and a cost-effective source of funding on the other.

10.3 Feedback from the industry

At present, most of the issuers involved are not planning to develop any initiative in this market segment in the next two years' horizon. The main reason is the lack of a dedicated and robust legislative framework, as well as of supervisory and prudential regulation. Respondents are particularly interested in knowing whether the instrument will be granted the same regulatory treatment of covered bonds, and chiefly the exemption from bail-in, the eligibility for repo collateral and purchase programmes of the ECB, and a high standard of eligibility under the rules for HQLA and the LCR. This lack of regulation creates a stalemate: on one side, while potentially interested in the introduction of the ESN, the industry does not intend to be the first mover in absence of well-defined rules, while on the other side policymakers find it hard to create a case in promoting an instrument that is not present in the market.

Looking forward, most respondents welcome the introduction of a pan-European financial instrument like an ESN, with some caveats. However, some institutions (mostly German) stress that the future framework shall be kept well separated from the existing regulation, to avoid disruption of the market integrity of covered bonds and possible negative spillover to the latter. Put differently, ESNs shall be regulated outside the context of the CBD and shall need a clear and strict definition of the assets allowed in the cover pool. Institutions located in other countries (chiefly in Italy and Spain) advocate instead for an alignment of the future ESNs regulation to the CRR and most importantly to the CBD, bringing in in several examples of possible benefits. ([326])

It is indeed very interesting to note that interest in developing a new financial instrument differs across Europe. In particular, in consolidated covered bonds markets, such as those in northern Europe, new regulatory action in this direction generally attracts less interest (with exceptions). In contrast, many issuers in southern Europe have declared to be very keen on introducing a voluntary framework for ESNs, motivated by the high relevance that the SMEs has in their respective economies, and consequently the importance of securing affordable financing specifically targeted to this sector.

([326]) Among the benefits of the new product, issuers cite a deeper market integration at EU level, the possibility to channel affordable funding to a sector that is vital for the real economy, the possibility to diversify their financing sources, a way to speed up the transition to a greener economy, the introduction of a new asset class that can be interesting for new categories of investors (especially retail), which is also among the objectives of the SIU.

Investors are also timid in welcoming ESNs on the market before assessing the guarantees that the instrument is expected to have in terms of liquidity (i.e. whether they can be considered HQLA or not), of granularity and composition of the cover pool, and of favourable regulatory treatment (RWA, LCR, repo eligibility) low RWA, high LCR and repo eligibility, in line with covered bonds. Other typical features of covered bonds, such as over-collateralisation and maturity extension, are also envisaged.

Yet, analysts warn that ESNs, while having the potential to attract new categories of investors and hence boost SMEs financing across the EU (and ultimately contributing to SIU in a sector which at present is mostly country-specific), may not be perceived as attractive by investors traditionally active in covered bond markets, especially in the absence of a premium with respect to covered bonds, like unsecured senior bonds, and securitisations. From the issuers' perspective, not much has changed in terms of interest for alternative sources of financing since the publishing of the EBA Report on ESNs of 2018, likely because of the high levels of liquidity due to an accommodative monetary policy (and a wide enough covered bonds market to complement it). In this regard, the start of monetary policy unwinding may prove crucial for the ESNs to gain momentum and renewed interest, especially if coupled with a sustained growth of SMEs activity.

Rating agencies point out the risk factors traditionally attributed to SME financing (i.e. the pro-cyclicality of the sector, the sector and loan concentration, and a heterogenous debt mix). In addition, in their view this type of instrument will likely be less liquid, and harder to refinance. Given the lack of experience in rating this type of instrument, agencies will likely turn to an approach based on methodologies already employed for similar products (covered bonds and SMEs ABS, the latter of which show – in some countries – a big enough market to justify interest in providing ratings). Evaluation would thus consider the intrinsically riskier nature of ABS (with respect to residential mortgages) on one side, but also the risk mitigation granted by the dual recourse mechanism on the other. Finally, it is also important to point out that the current lack of harmonisation of risk measures for SMEs exposures across Europe results in a lack of transparency and comparability, which is key for a rating agency to establish a useful risk assessment to inform investors.

10.4 Policy assessment

The introduction of ESNs may bring multiple benefits. From an issuer perspective, banks with a relatively lower credit rating and consequently more constrained market access would find in ESNs a valid funding alternative, especially if they hold large SMEs portfolios that they can employ as collateral. This is often the case for smaller banks in countries without a solid tradition of covered bonds issuance. From the SMEs perspective, the existence of a covered bond-like instrument asset that improves the risk profile of the issuer by the constitution of a secured cover pool of collateral, and that is granted as a consequence a favourable treatment by the regulation would ultimately result in a financing of their activity in a cost-efficient manner. Finally, from a macro-prudential point of view, ESNs can act as a countercyclical tool to shield small banks from the deterioration of the quality of their SMEs portfolios during downturns, and hence of their profitability and credit quality, and grant continuity to the financing of economic activity.

However, the development of ESNs faces a few challenges. Given the usually higher default rate of SME loans when compared to residential mortgages, the lack of securing options, the high degree of heterogeneity and complexity of the loans' portfolios, the lack of formal LTV tests to assess the degree of risk, and the intrinsically shorter life of the assets (which would require frequent replenishment of the cover pool composition), the instrument would have to be backed by stronger guarantees, chiefly a higher degree of over-collateralisation. Indeed, setting commensurate levels of collateralisation (evaluated in the EBA's 2018 report to be equal to 30%) is essential to avoid market distortions in which better-rated issuers are crowded out given the higher burden, and worse-rated issuers are encouraged to enter the market.

10.5 Conclusions and policy recommendations

Despite the support given by the new insight from the industry, the EBA acknowledges that there is currently little political support for a policy initiative to stimulate such an instrument in absence of market developments and clear political indications from EU bodies. Drawing a parallel with other market segments, should there be the need for an alternative financing instrument for SMEs arise, it will be up to the market to take up the role of first mover.

At the same time, the EBA acknowledges the outcome of the recent COM consultation with the industry on securitisation as a funding tool for SMEs. ([327]) Many respondents identified SMEs as having only limited access to securitising loans, with regulatory complexity, high costs, and lack of data quality being the major impediments. This in turn hinders risk evaluation and ultimately investor interest. In addition to this, unfavourable prudential treatment of securitised loans, including higher capital requirements under the Basel III framework, are highlighted as discouraging investments in SMEs securitisation.

In view of the above, as it seems that at present securitisations is not sufficiently suitable for SMEs funding, the EBA recommends a review of the topic in the medium term to assess market development and interest to use ESNs as a complement to synthetic securitisation. ([328]) In this regard, the EBA remarks that the industry has already hinted to the intention of issuing a first ESN prototype in the near future.

([327]) See the Targeted consultation on the functioning of the EU securitisation framework.

([328]) This review supports the current view of COM expressed in the Proposal for the revitalisation of the securitisation market in the near future (see the Proposal amending Regulation (EU) 2017/2402).

11. COVERED BONDS WITH EXTENDABLE MATURITIES AND LIQUIDITY REQUIREMENTS

KEY TAKEAWAYS OF THIS CHAPTER

EXTENDABLE MATURITIES (ARTICLE 17 OF THE CBD)

The CBD allows for covered bonds with extendable maturity structures. This feature has been designed to offer the investor an additional guarantee of an orderly winding-down of the cover pool after the estate separation has occurred, avoiding the fire sales that a hard maturity would imply instead. At the same time, it should release the burden on issuers, allowing for higher credit ratings on their bonds' 'timely payment'. The extension of the maturity shall never be indefinite, nor shall it undermine the dual recourse structure of the instrument. Most Member States have chosen to allow for this discretion in the transposition of the Directive.

The CBD lays down rules for the exercise of the discretion, with the overarching principle of ensuring that the maturity extension is triggered for the benefit of the investor, rather than to solve issuer problems unrelated with its default.

In reviewing the implementation of the Directive in the Member States, the EBA proposes a number of amendments to reiterate the covered bond investor protection principle associated with extendable maturity structures. All recommendations have as a common trait a more active involvement of both the NCA and the investor in the control of the issuer's involvement in the extension, where such extension may occur prior to the estate separation.

In particula**r, the EBA ac**knowledges that the circumstances that may initiate the extension process are often unclear and largely left at the discretion of the issuer. Therefore, **the EBA recommends Member States to define clearly, via their respective NCAs, the extension triggers with an objective and finite list of events** that must be verified to be in line with said protective principle.

In addition, the EBA notes the importance for Member States to control the actual trigger realisation individually, and to assess the responsibilities of the issuer in the extension. Therefore, t**he EBA recommends the NCAs perform an assessment of the involvement of the issuer in the run-up to the realisation of the trigger**. The justification for this assessment is to avoid a scenario where the issuer to extend the maturity to solve problems that are unrelated to its insolvency risk.

Lastly, **the EBA recommends the active involvement of the investor in the follow-up to an extension**, with the ultimate goal of performing an ad-hoc unlikeliness to pay assessment to rule out the possibility of an embedded forbearance measure.

Liquidity requirements (Article 16 of the CBD)

The CBD lays down rules for the constitution and the utilisation of the liquidity buffer, a pool of highly liquid assets to cover net outflows for the next 180 days following the passage from the first to second recourse. However, the Directive allows for the discretion to be used, in the calculation for the 180 days of coverage, the final maturity date (i.e. the final legal maturity that would have to be met following a maturity extension).

The EBA focused its analysis on the validity of this discretion. Allowing for principal outflow recognition based on final legal maturity would leave the covered bond estate without the necessary liquidity means to guarantee the scheduled repayment of covered bond principal amount, thus effectively prompting extension, unless the issuer is able to fund these outflows from its general estate. Where such maturity extension may occur prior to estate separation, the issuer will soon or later have to comply with liquidity coverage requirements related to the extended covered bond principal amounts, which may not be extended a second time.

This leaves the covered bond estate (which is meant to be protected by both the liquidity coverage requirement and the potential maturity extension against the risk of a non-orderly wind down) fully dependent of the issuer's ability to ramp up the covered bond liquidity buffer in the time by which the maturity extension exceeds 180 days.

To overcome this issue, **the EBA recommends introducing additional conditions to** continue allowing the **use** of **the discretion in conjunction with maturity extension possible prior to estate separation**, all aimed at guaranteeing the presence of an adequate liquidity buffer in the interest of the investor. In particular, the **objective maturity triggers shall be consistent with the assumption that an issuer will be able to extend in case it will be unable to meet principal payment obligations** (this recommendation does not apply to match funding covered bond models due to their ability to guarantee liquidity in case of the verification of model-specific triggers). In addition, upon depletion of the buffer, **the issuer shall either have a protection scheme in place for which other institutions can step in providing liquidity, or an approved plan where it clearly outlines how to replenish the said buffer**.

Finally, **the EBA recommends some technical clarifications to the calculation of the liquidity buffer** to better account for net outflows mismatches.

11.1 Extendable maturities

11.1.1 INTRODUCTION

Article 17 of the CBD allows Member States – in transposing the Directive – to exercise the discretion to allow the issuance of covered bonds with extendable maturity structures, ([329]) provided that some requirements are respected:

- The admissible extension triggers shall be always objective (i.e. not at the discretion of the issuer) and specified in the national law.
- The triggers shall be clearly specified in the terms and conditions of each covered bond issuance.

([329]) In accordance with Recital 17 of the CBD 'extendable maturity structure' means a mechanism which provides for the possibility of extending the scheduled maturity of covered bonds for a pre-determined period of time and in the event that a specific trigger occurs.

- A set of minimum information on the maturity structure, including a description of the extension triggers, the consequences of an extension in case of insolvency or resolution of the issuer, and of the role of competent authorities or (if relevant) the special administrator shall be given to the investor for a proper assessment of the product risk.
- The final maturity date shall be always determinable.
- In case of insolvency or resolution, the extension shall not affect the ranking of covered bond investors or invert the original sequencing of payment from the covered bond programme.
- The extension shall not affect the dual recourse and the bankruptcy remoteness of the covered bond.

In addition to the above, Member States allowing extendable maturity structures are to notify the EBA about the utilisation of such discretion.

11.1.2 EXTENDABLE MATURITIES FRAMEWORKS IN THE EU

The questionnaire addressed to the NCAs collected information on the provisions that rule covered bond with extendable maturity structures. A thorough overview of the results can be found in Figure 27.

The vast majority of Member States reported that they allow the use of covered bonds with extendable maturities. All of these countries allow for soft bullet covered bonds. ([330]) Only three countries also allow issuing CPT covered bonds ([331]) but either, there is no formal distinction between soft bullet and CPT in the legislation, or there has not been an effective issuance.

As to the requirement set forth in Article 17(1)(a) of the CBD, the objective maturity extension triggers specified in law largely vary from country to country. Many allow for an extension due to insolvency of the issuing bank, while some other common triggers are 'failure to pay' ([332]) and liquidity issues of the issuing institution. In some countries, triggers are unspecified and are left solely to contractual terms.

Fifteen countries allow maturity extension before the resolution/insolvency of the issuing/parent bank. Out of these, some do not define by law the underlying reasoning for the trigger (i.e. whether it is liquidity or credit driven), whereas some others set triggers that are solely related to liquidity issues, or that are credit related.

([330]) [ECBC definition] Soft bullet covered bonds have a scheduled maturity date and an extended maturity date. If objective, predefined and transparent criteria have been met, the maturity of a soft bullet covered bond can, and in some cases will automatically, be prolonged up to the extended maturity date. During the extension period, the covered bond may be redeemed using cover pool proceeds.

([331]) [ECBC definition] Conditional pass-through (CPT) covered bonds have a scheduled maturity date and an extension mechanism. By itself, the failure to repay the CPT covered bond on the scheduled maturity date does not lead to an acceleration of this covered bond but to an extension of the maturity date of this and potentially other relevant covered bonds. The extension requires that objective, predefined and transparent criteria are met. In such circumstances, the maturity of a CPT covered bond can be prolonged to the extended maturity date, which is typically linked to the maximum legal maturity of the underlying assets. During the extension period, cash-flows received or generated from the cover assets will be distributed to the covered bonds investors. Regular attempts are in general made to sell the cover pool assets to redeem the covered bonds. Such sales are subject to predefined criteria intended to protect the interests of all investors under the same programme. In certain jurisdictions and programmes, CPT covered bonds may feature an initial soft bullet extension.

([332]) This trigger shall not be intended as a prerequisite for the covered bond issuer to have actually failed to make a payment when due – be it on the covered bonds or any other kind of due payment – but rather the expectation by the issuer to not be able to meet upcoming payments when falling due.

Figure 27: Overview of the different national legislation frameworks on extendable maturities

Member State	Extension type	Extension before insolvency	Objective triggers	Use of final maturity in liquidity buffer (Article 16(5) of the CBD)	Formal involvement of CA in the extension process	Scope of extension	Maximum extension time
Austria	SB	No	Insolvency/resolution	No	No	Not specified (333)	12 months
Belgium	SB	Yes	Insolvency/resolution, failure to pay	Yes	Yes (334)	Principal	12 months
Bulgaria	SB, CPT	Yes	Failure to pay, liquidity issues/financial environment	Yes	Approval	Principal	Maturity of the primary asset
Cyprus	SB, CPT (335)	Yes	Insolvency/resolution, (336) failure to pay, (333) liquidity issues/financial environment, (337) authority decision	Yes	Approval	Not specified	No
Czechia	SB	No	No (338)	Yes	No	Principal, interest	No
Denmark	SB	Yes	Liquidity issues/financial environment	Yes	Notification	Principal	12 months, No (339)
Estonia	SB, CPT (332)	No	Insolvency/resolution (333)	Yes	No	Principal, interest	No (330)
Finland	SB	Yes	Liquidity issues, financial environment	Yes	Approval	Not specified (330)	No (330)
France	SB	Yes	Insolvency/resolution, failure to pay	Yes	No	Not specified (330)	No

(333) Must be specified in the terms and conditions of the covered bond.

(334) Post-trigger verification.

(335) Conditional pass-through has never been used in practice.

(336) As one of the factors considered as part of an overall assessment performed by the NCA.

(337) As one of the factors (in the form of an assessment of the impact of non-extension/inability to issue new bond on same terms).

(338) The triggers are contractually agreed and specified in the terms and conditions.

(339) Depending on whether the trigger is the interest rate or the impossibility, respectively.

Member State	Extension type	Extension before insolvency	Objective triggers	Use of final maturity in liquidity buffer (Article 16(5) of the CBD)	Formal involvement of CA in the extension process	Scope of extension	Maximum extension time
Germany	SB	No	Insolvency/resolution	No	No	Principal, interest (340)	12 months
Greece	SB, CPT	Yes	Failure to pay	Yes	Notification	Principal, interest	No
Hungary	SB	Yes	No (330)	No		Not specified (330)	12 months
Ireland	SB, CPT (332)	Yes	Failure to pay, authority decision	Yes	Request	Principal, interest (341)	No
Italy	SB, CPT (342)	Yes	Insolvency/resolution, failure to pay, authority decision	Yes	Notification	Not specified	No (330)
Lithuania	SB, CPT (332)	Yes	Failure to pay, authority decision	Yes	Approval	Not specified (330)	No
Luxembourg	SB	No	Insolvency/resolution	Yes (343)	Notification/request (344)	Principal, interest	12 months
Netherlands	SB, CPT	Yes	Insolvency/resolution, failure to pay	Yes	Notification	Not specified (330)	No
Poland	SB, CPT (345)	Yes	Insolvency	Yes	No (346)	Principal	12 months (347)

(340) Interest payable within the first month of estate separation may be extended – unconditionally – to the end of that first month

(341) Only subject to authority decision.

(342) There is no legal distinction between soft bullet and conditional pass-through.

(343) As per Article 9 of the Law of 8 December 2021 relating to the issue of covered bonds.

(344) As per Article 152 and 154 of the Law of 18 December 2015 on the failure of credit institutions and certain investment firms.

(345) The extendable maturity structure is a combination of soft bullet and conditional pass-through.

(346) NCA or resolution authority only lodges motion for initiation of insolvency proceedings of a mortgage bank.

(347) With possibility to subsequent extensions up to three additional years' subject to certain coverage and liquidity tests. The additional extension of three years is calculated starting from the maturity of the latest cover asset entered in the pool, so the total extension period can theoretically exceed four years altogether.

Member State	Extension type	Extension before insolvency	Objective triggers	Use of final maturity in liquidity buffer (Article 16(5) of the CBD)	Formal involvement of CA in the extension process	Scope of extension	Maximum extension time
Portugal	SB, CPT	Yes	Insolvency/resolution and failure to pay	Yes	Notification ([348])	Principal, interest	No
Romania	-	-	-	-	-	-	-
Slovenia	SB	No	Insolvency/resolution	Yes	No	Principal, interest	13 months ([349])
Slovakia	SB	No	Insolvency/resolution	No	Approval	Principal	24 months ([350])
Spain	SB, CPT ([332])	Yes	Insolvency/resolution, liquidity issues/financial environment	No	Approval	Not specified ([330]) ([351])	No ([352])
Sweden	SB	Yes	Failure to pay ([353])	Yes	Approval ([354])	Not specified ([355])	No ([330]) ([351])

([348]) With the possibility for the NCA to oppose to the extension within ten days from the notification.

([349]) Only for principal payment. The maximum for interest payment is one month.

([350]) With a minimum of twelve months.

([351]) It is market practice to extend only the principal.

([352]) Market practice is twelve months.

([353]) The maturity can be extended if the extension is likely to prevent the issuers default.

([354]) Approval by the authority shall be remitted to the Swedish central bank and the Swedish National Debt Office.

([355]) It should be specified in the terms and conditions. Current market practice is to extend both the principal and the interest.

11.1.3 FEEDBACK FROM THE INDUSTRY

The questionnaire addressed to the industry gathered information on six subjects related to covered bonds with extendable maturities, namely:

- pricing differences between hard and soft bullet instruments;
- the perception of risks across different instruments;
- characteristics and standards of the extendable bonds (for instance, interest rate structure);
- opinions regarding the application of the maturity buffer beyond the date of the final maturity;
- quality and standardisation of investor information;
- rating methodology.

Analysts confirmed that there is no difference in pricing between hard and soft bullet structures. Other characteristics are more important (bond size, coupon, issuance date, maturity, etc.) in determining the spreads between the two maturity structures. From the rating agencies' perspective, the possibility of mitigating the principal payment interruption risk usually allows rating grades, all else being equal.

In terms of risks, conditional on a situation of insolvency, hard bullet structures would imply a faster repayment by accelerating dual recourse on the issuer if the cover pool turns out to be not enough. However, it could expose investors to an unorderly winding down of the cover pool, while soft bullet structures can be beneficial to an orderly liquidation.

Regarding CPT instruments, some participants point out their riskier nature, as opposed to soft bullet, given the longer maturity extension allowed, ex-ante uncertainty about the day of repayment, but most importantly because of the high correlation with issuer size and credit worthiness. Overall, the instrument has proved unpopular with investors, so much so, it has been excluded from the ECB's CBPP3. [356] Conversely, issuers claim that CPT structures are essential, when it comes to tapping the market in times of market turmoil where it acts as a countercyclical tool whenever financing via other instruments become difficult. It is likely because of this feature, that rating agencies generally grant more notches to the rating.

The survey confirmed that there are different market standards as to the post-reset coupon, which span from floating (for instance, Euribor 3m plus a spread like in Spain), to fixed (for instance, initial coupon plus 500 bp like in Denmark, which is even regulated by Danish law). In Germany, Pfandbrief require in absence of diverging contractual clauses to at least apply the same coupon rate in place before the extension, which, despite this rule primarily aiming at covered bonds, which had been issued before entry-into-force of the law-based extension scheme, is being made use of with regard to newly issued covered bonds as well. Conversely, other countries do not have a market standard.

Higher standardisation would be welcome in the disclosure of the explanation of trigger events and characteristics of the post-reset coupon (interest rate information is generally gathered by reading the factsheet of the final terms, which is difficult and time-consuming). Some investors demand a premium on coupon after default to cover from higher risk of full repayment and illiquidity, while in other cases the premium is set by national regulation.

Finally, there is a wide consensus, among analysts and rating agencies, against including the period beyond the expected maturity date in the 180 days liquidity buffer. For rating agencies, the risk of a zero buffer (and hence lack of compensation in case of cashflow delay) materialising for extensions above 180 days results in lower rating grades. Investors dislike the large heterogeneity in the use of this discretion (Article 16(5) of the CBD) across jurisdictions (for instance, Italy and France exercise it, whilst Germany and Spain do not), as it creates uncertainty and ultimately results in less market integration.

(356) Although they remain eligible for repo operations.

11.1.4 POLICY ANALYSIS

Overall, the analysis of information received by NCAs shows that there is a high degree of heterogeneity in the implementation of the provisions set forth in Article 17 of the CBD. In detail, the EBA notes that:

- Triggers are not always objectively specified in the national legislation, leaving the matter to the contractual terms of the issuance.
- There is a high degree of heterogeneity on the role of the issuer to extend upon the realisation of the objective trigger and with respect to the involvement of the NCA and the special administrator. Depending on the jurisdiction, extension can be triggered:
    - automatically upon the realisation of the triggers;
    - by the issuer, with a certain involvement of the NCA in authorising the extension;
    - upon request to the supervisory authority;
    - by decision of the special administrator after insolvency.

There is uncertainty on the prudential treatment of an extension if it happens before default/resolution of the issuer. In many Member States, the national legislation has set up a 'failure to pay' criterion as an objective trigger for the extension of maturity. In the context of such a trigger, the issuer could be seen as having some sort of control on triggering the extension, if only by choosing to extend covered bond payment obligations in order to be able to meet non-extendible payment obligations maturing shortly after the covered bonds' obligations.

Theoretically, there could be some situations where the issuer would not act adequately in the run-up to the payment of the obligation, which results in it being unable to pay. In such cases, the 'failure to pay' criterion may be seen as objectively specified in the legislation, but not necessarily entirely out of the scope of control from the issuer. Typically, this extension could be exercised in the case of a major liquidity or credit related event.

For the cases where the extension trigger is credit-related, there is no specific reference in the regulatory framework to the requirement to check the unlikeliness-to-pay criteria as provided by Articles178(1)(a) and 178(3) of the CRR or any other indication of unlikeliness to pay as referred to in the EBA GLs on DoD. ([357]) In any case, it should be noted that institutions and market analysts highlight the reputational risks of an extension, which acts to dis-incentivise issuers from extending.

11.1.5 CONCLUSIONS AND POLICY RECOMMENDATIONS

The EBA elaborated its recommendations alongside the three dimensions related to maturity extension as provided for by Article 17 of the CBD:

- the objectivity of the triggers defined in the legislation, including the assessment of compliance with Article 17(1)(a) in case there is a lacking definition of objective triggers in national legislation;
- the absence of a role of the issuer in the run-up to the realisation of triggers (i.e. before the realisation, especially in the case of the 'failure to pay' trigger), as well as the nature of the extension (liquidity or credit related);
- the role of the investor in the follow-up of the extension to assess whether there may be an unlikeliness to pay scenario.
- The first and second points are relevant in the context of extension before the insolvency or resolution of the issuing bank, as after such case, the issuer's role is not a concern anymore considering the intervention of the resolution authority. In any case, the role of the authority in ensuring the objectivity of the triggers by checking the unavoidability of the realisation of the triggers and assessing the merit of forcing the maturity extension is a key aspect to be considered.

([357]) See the Guidelines on the application of the definition of default under Article 178 of Regulation (EU) No 575/2013 (EBA/GL/2016/07).

- In addition, in the context of extension before the insolvency or resolution of the issuing bank, the EBA is of the opinion that institutions, in their roles as investors, should conduct an in-depth assessment, in particular, of whether the extension results in any of the indications of unlikeliness to pay set out in Article 178 (3) of the CRR or whether any other indication of unlikeliness to pay as referred to in the GLs on DoD are met. In particular, a good practice for institutions would be to perform an assessment to ensure that the possibility that the contractual clause may be considered as an embedded forbearance measure (as per Article 178(3)(d) of the CRR), depending on the agreed terms and conditions applicable for the period after the extension.

Recommendation 20. *On the objectivity of the triggers.*

The EBA recommends avoiding giving discretion to the issuer in defining the extension triggers in the contractual terms, by specifying them instead in national law (as required by the CBD), in the form of an exhaustive and objective list of events.

The overarching principle that should guide the definition of objective triggers and consequently what shall be verified by the NCA is the ability to capture a disruption in the market or a critical situation of the issuer that makes it effectively unable to guarantee the payments when they fall due.

Recommendation 21. *On the role of the issuer in the run-up to the realisation of the trigger.*

Where extension may occur prior to estate separation, the EBA recommends an active involvement of the NCA with the aim of reducing the possibility for the issuer to act against the best interest of the covered bond investors in the run-up to the realisation of the trigger. More specifically, the NCA should be able to conduct an inquiry to verify whether all reasonable measures have been put in place to avoid the realisation of a failure to pay situation (for instance, via a thorough analysis of the cash flows or the remedies put in place to mitigate this possibility).

Recommendation 22. *On the role of the investor in the follow-up on the extension.*

Where extension occurs prior to estate separation, the EBA recommends – for institutions investing in the covered bond – to follow-up on the extension by an ad-hoc unlikeliness to pay assessment. This assessment should also reflect the nature of the extension (i.e. whether credit or liquidity-based) as well as the control of the issuer in leading to the realisation of the trigger, i.e. the optionality to extend (or not). The assessment shall exclude that the extension should be treated as an embedded forbearance measure in accordance with Article 47b of CRR. Clearly, the ad-hoc nature of the assessment shall by no means translate into a compulsory NPV test, but rather in the possibility to perform it in the context of the assessment where relevant.

11.2 Liquidity requirements

11.2.1 INTRODUCTION

Article16 of the CBD sets out minimum requirements for the coverage of the covered bond estate's liquidity needs for the first 180 days after estate separation:

- Coverage of the maximum cumulative net liquidity outflow over the next 180 days by the liquidity buffer cover assets.
- Liquidity buffer cover assets classified as LCR Level 1, Level 2A and 2B HQLA (generally excluding HQLA issued by members of the covered bond issuer's group), and short-term exposures to minimum CQS 2 credit institutions or short-term deposits with minimum CQS 3 credit institutions.
- Uncollateralised cover assets in regulatory default must not contribute to liquidity coverage (neither as a liquidity buffer cover asset, nor as liquidity inflows).
- Deviations from this general principle by way of:
  - the option to allow – for the principal amount's outflow of covered bonds whose maturity may be extended – to be considered at their final maturity (even before extension happens);
  - an exception from Article 16 of the CBD for covered bonds subject to a match funding requirement in accordance with Article 3(15) of the CBD.

11.2.2 THE LIQUIDITY REQUIREMENTS FRAMEWORKS IN THE EU

The EBA collected information regarding the liquidity requirements across national legislations based on the answers received from the questionnaire addressed to NCAs. A thorough overview of the results can be found in Figure 28.

There is high heterogeneity on the restrictions applied to cover assets to be used for liquidity buffer purposes as per Article 16(3)(1) of the CBD (some jurisdictions exclude all or some short-term exposures to credit institutions, other exclude anything but credit institution exposures, some have in place additional requirements on credit institution exposures, some allow central bank-eligible collateral only, others exclude Level 2A or 2B HQLA). A majority of Member States requires liquidity buffer cover assets to be generally cover-eligible.

Of the Member States that do not apply restrictions, only two (Austria and Italy) do not require assets to be generally cover eligible for liquidity buffer purposes. ([358]) One of these Member States (Italy) explicitly excludes non-cover eligible liquidity buffer assets from general coverage contribution under Article 15 of the CBD.

A majority of Member States transposed the implicit calculation process provided for by Article 16(2) of the CBD either literally (i.e. without further specification of that implicit calculation process), or more in detail, but with crucial elements of that calculation apparently missing. Only eight Member States did not make use of Article 16(5) of the CBD. None of the Member States using this option requires other safeguards than those required under Article 17 of the CBD. The relevance of Article 7(2b) of the LCR-DR is confirmed by two Member States (France and Spain).

([358]) This *per se* may raise issues for an insolvency administrator, in that it challenges segregation of cover-ineligible liquidity buffer assets.

Figure 28: Overview of the different national legislation frameworks on liquidity requirements

Member State	Liquidity coverage stricter than Article 16(3) of the CBD	Liquidity buffer assets to qualify as cover asset	Mechanics of maximum cumulative net liquidity outflow	Additional safeguards for use of Article 16(5) of the CBD	Article 7(2b) of the LCR-DR relevant
Austria	No	No	Literal transposition	Option not used	No
Belgium	Yes ([359])	Yes	Specified calc.	Option used / No add. safeguards	No
Bulgaria	No	Yes	Specified calc.	Option used / No add. safeguards	No
Cyprus	Yes	Yes	Literal transposition	Option used / No add. safeguards	No
Czechia	No	Yes	-	Option not used	No
Denmark	Yes ([360])	Yes	Literal transposition	Option used / No add. safeguards	No
Estonia	No	Yes	Specified calc.	Option used / No add. safeguards	No
Finland	Yes ([361])	Yes	Literal transposition	Option used / No add. safeguards	No
France	No	Yes	No specification ([362])	Option used / No add. safeguards	Yes
Germany	Yes ([363])	Yes	Specified calc.	Option not used	No
Greece	No	Yes	Literal transposition	Option used / No add. safeguards	No
Hungary	No	Yes ([364])	Literal transposition	Option not used	No

([359]) Only Level 1 assets and Article 16(3)(1)(b) of the CBD assets.

([360]) Only Article 16(3)(1)(a) of the CBD assets.

([361]) Only Article 129 of the CRR-eligible liquidity buffer cover assets.

([362]) Issuer shall ensure that liquidity requirements are covered at all times over a period of 180 days, taking into account forecast flows of principal and interest on its assets as well as net flows relating to the forward financial instruments.

([363]) Additional requirements for Article 16(3)(1)(b) of the CBD: minimum CQS (external rating) of 2, restriction by country of establishment (EU/EEA, CA, CH, JP, UK, US) subject to Article 107(4) of the CRR, similar supervisory regime for institutions exempted in accordance with Article 2 of the CRD, no group member of issuer.

([364]) As permitted lending at specialised mortgage credit institution level.

Member State	Liquidity coverage stricter than Article 16(3) of the CBD	Liquidity buffer assets to qualify as cover asset	Mechanics of maximum cumulative net liquidity outflow	Additional safeguards for use of Article 16(5) of the CBD	Article **7(2b)** of the LCR-DR relevant
Ireland	Yes ([365])	No	Literal transposition	Option used / No add. safeguards	No
Italy	No	No ([366])	Increasing increments ([367])	Option used / No add. safeguards	No
Lithuania	No	Yes	Literal transposition	Option used / No add. safeguards	No
Luxembourg	No	Yes	Specified calc. ([368])	Option not used ([369])	No
Netherlands	No	Yes	Literal transposition	Option used / No add. safeguards	No
Poland	No	Yes	Literal transposition	Option used / No add. safeguards	-
Portugal	No	Yes	No incremental calc. ([370])	Option used / No add. safeguards	No
Romania	Yes ([371])	Yes	Specified calc. ([365])	Option not used	No
Slovenia	No	Yes ([372])	Literal transposition	Option used / No add. safeguards	No

([365]) Only Article 16(3)(1)(b) of the CBD assets.

([366]) Non-cover eligible liquidity buffer assets not to contribute to general coverage (Article 15 of the CBD).

([367]) Bucketing approach for the calculation of the maximum cumulative net liquidity outflows, using the same time bands of COREP maturity ladder template (C 66), i.e. with the length of bands increasing over the 180 days.

([368]) No mention of incremental aggregation (steps 2 and 3).

([369]) Hard bullet only.

([370]) Issuers must calculate the net liquidity position by subtracting the total expected cash outflows from the total expected cash inflows over the 180-day period.

([371]) Only central bank-eligible assets without payment defaults.

([372]) In addition, liquidity buffer shall be entered into the cover register and be separated from other liquid assets.

Member State	Liquidity coverage stricter than Article 16(3) of the CBD	Liquidity buffer assets to qualify as cover asset	Mechanics of maximum cumulative net liquidity outflow	Additional safeguards for use of Article 16(5) of the CBD	Article **7(2b)** of the LCR-DR relevant
Slovakia	Yes ([373])	Yes	Specified calc. ([374])	Option not used	No
Spain	No	Yes	Specified calc. ([375])	Option not used	Yes
Sweden	Yes ([376])	Yes	Literal transposition	Option used / No add. safeguards	No

([373]) No short-term deposits with CQS 3 credit institutions.

([374]) A bank shall always cover net liquidity outflows from its covered bond programme with a liquid asset buffer whose value is at least equal to the maximum cumulative net liquidity outflow over the next 180 days. These liquid assets shall form the part of the cover pool. 'Net liquidity outflow' means all payment outflows falling due on one day, including principal and interest payments and payments under hedging derivative contracts of the covered bond programme, net of all payment inflows falling due on the same day for claims related to the cover assets.

([375]) Issuers perform the calculation on a monthly basis for the next 180 days following each of the days of that month.

([376]) Level 2B assets and short-term exposures to credit institutions that qualify for CQS 3 are only allowed temporarily under specific circumstances, subject to NCA approval.

11.2.3 FEEDBACK FROM THE INDUSTRY

The industry questionnaire addressed issuing banks, investors/analysts and rating agencies to get insight into the use of the final maturities in the liquidity buffer, and chiefly:

- what safeguards are required from issuing banks where the option of Article 16(5) of the CBD is exercised;
- what the view of investors or analysts is with respect to the use of Article 16(5) of the CBD;
- what rating methodology applies in case of Article 16(5) of the CBD being used.

Responses by issuing banks mainly focused on requirements applicable to managing liquidity risk by way of the LCR, NSFR, national risk management rules etc. as a justification for the use of final maturity. In some cases, the special mandate of the special administrator to raise liquidity was offered as a justification, as was the covered bond regime's implied understanding of the resolution of a failed issuer's covered bond estate by way of transfer of the covered bond programme to another issuer.

As a tendency, investors/analysts dislike the use of the discretion given in Article 16(5) of the CBD, though some perceive that its non-use may cost-prevent some potential issuers from tapping the market.

Rating agency responses reveal a decreasingly positive credit impact with an extension prior to or upon estate separation (with or without Article 16(5) of the CBD) and where the issuer needs to survive the extension.

More specifically, rating agencies are worried about the risk that considering the extended maturity date could effectively lead to a liquidity buffer of zero for some periods, notably if the extension exceeds 180 days. Rating agencies do take this issue into account when it comes to assessing the quality of the instrument.

11.2.4 POLICY ANALYSIS

The liquidity coverage requirements established by Article 16 of the CBD aim at ensuring a smooth transition into a post-issuer insolvency wind-down of the covered bond estate. (377) Such smooth transition is essential during the passage from the first to the second recourse. Effectively, the initial motivation for this requirement was to unburden the agent of the separated covered bond estate from having to deal with the immediate needs for raising liquidity. (378) The idea behind granting a period of 180 days to the special administrator to organise the management of the covered bond estate's stems from an assumed materially changed market access vis-à-vis that of the covered bond issuer prior to its default, as well as an assumed market perception of the special administrator to be acting not 'without compulsion'. (379) (380)

As a matter of fact, for many Member States, the liquidity buffer was a requirement new to the covered bond framework prior to the CBD transposition. Before the CBD, market practice had developed the concept of maturity extension (mostly soft bullet extension for a fixed, typically 12-month, period of time) to accommodate the operational needs of the wind-down covered bond estate post issuer insolvency. As competition to the soft bullet extension scheme, some issuers established conditional pass-through schemes, easing liquidity needs of a covered bond wind-down estate and thus increasing the resolvability of the covered bond estate even further – albeit

(377) Together with the principles of the coverage of future interest payable (Article 15(3)(1)(b) of the CBD) and the expected cost of wind-down of the covered bond estate (Article 15(3)(1)(d) of the CBD), as well as the requirement for derivative contracts included in the cover pool not to be terminated upon issuer insolvency (Article 11(1)(d) of the CBD), in the interest of the covered bond estate's capability to be resolved in an orderly fashion (the principle at the core of Article 5 of the CBD), which can be modified only by allowing maturity extensions under the conditions of Article 17 of the CBD.

(378) The agent is in many cases the covered bond estate's special administrator as per Article 20(2) and (3) of the CBD.

(379) The quantification of the liquidity coverage requirement as per the instrumental definition of 'net liquidity outflow' in Article 3(16) of the CBD is based on contractually scheduled payment inflows, corrected for obligor or facility default by de-recognising future inflows of defaulted uncollateralised cover assets in accordance with Article 16(3)(3) of the CBD.

(380) For instance, no euro system access as 'wind-down entity' in accordance with Article 55a(5) in conjunction with Article 2(99a) of ECB Guideline (EU) 2015/510, the conditions for access of which will likely be similarly applied by privately organised funding platforms.

to the detriment of covered bond investors – who in fact became more akin to investors into private credit funds. Both extension schemes enabled rating agencies to lower over-collateralisation requirements in light of possibly less severe scenarios. On the other hand, the post-issuer insolvency covered bond estate would need to be able to withstand the timeliness of meeting payment obligations.

The logic of this relaxation of coverage expected to be provided by issuers translated within the CBD into the discretion provided by Article 16(5) of the CBD to base the determination of the maximum cumulative net liquidity outflow for extendable covered bonds on the covered bonds' principal outflows' final (i.e. extended) maturity, thus typically deferring these outflows to beyond the next 180-day period relevant for the CBD's liquidity coverage requirement. In contrast, under LCR rules, recognition of a possible maturity extension as deferral of the associated outflows would require the extension to have actually occurred, and not its mere possibility.

By exercising the discretion set forth in Article 16(5), national regulation implicitly allows for the maturity extension to be used as a means to solve some liquidity problems for the issuer.

There is indeed an undesirable link between the definition of the triggers and the exercise of the discretion set forth in Article 16(5) of the CBD, in that by allowing the final maturity in the calculation of the liquidity buffer, the national regulators are implicitly assuming that extension can always be exercised upon an issuer's inability to pay covered bond obligations, as they fall due. Therefore, the extension triggers specified in the law shall be consistent with this assumption. This means that, for Member States that allow extension before the insolvency/resolution of the issuer (or its parent institution in case of France), the exercise of the option in Article 16(5) shall be combined with an extension trigger equivalent to a 'failure to pay' condition.

However, even when the triggers are consistent with the exercise of the option in Article 16(5), this does not mean that the investor is at any time adequately insured against the liquidity risk. In the event of maturity extension happening before insolvency or resolution of the issuing bank, there can be implications on the liquidity risk that covered bond investors may be exposed to in case the issuing bank would default between the date of the extension and the next 180 days. In other words, if this happens, there could be no liquidity buffer to serve the obligations to covered bond investors, as there would be no possibility to extend a second time.

Moreover, by exercising this discretion the issuer is *de facto* transferring the cost of holding liquid assets for longer than the LCR 30-day period in advance to the covered bond investor, who is covering this extra risk by allowing the issuer to extend to cover for liquidity needs.

By not restricting the possibility of maturity extensions to the issuer insolvency or resolution (i.e. in situations where the first layer of recourse of covered bond creditors to the issuer ceases to be valid), ([381]) a number of Member States decided for covered bonds' maturity extension to also be available for the benefit of the issuer's 'survival'. While the issuer's survival may be justified in the overall interest of covered bond creditors as well, ([382]) the risk of the survival not being sustainable is borne to large extent by the covered bond holders. The risk the investors may face is that the estate separation occurs without the ability to extend again or having available and sufficient liquid cover assets.

Overall, the degree of protection added for covered bond investors by introduction of the liquidity buffer requirement in Article 16 of the CBD very much depends on Member States' choices with regard to the discretions set in Article 16(5) and (6) of the CBD, Article 17 of the CBD, as well as in the related technical implementation of the calculation for determining the maximum cumulative net liquidity outflow.

([381]) This includes extension schemes established primarily for market disruption scenarios irrespective of an issuer's ability to repay covered bonds at their scheduled maturity.

([382]) For instance, for ongoing clearance of the cover pool from defaulted cover assets or management of foreign exchange and interest rate risk.

On the one hand, this calculation relies aggressively on the immediate operational availability of contractually scheduled cash inflows (and on the fact that these inflows will continue in accordance with that schedule despite issuer insolvency), as well as on the ability of the cover assets in the liquidity buffer to effect payment outflows falling due upon estate separation. On the other hand, it assumes – perhaps conservatively – that missing payment obligations of any magnitude or for any duration would constitute grounds for legal action against the covered bond estate that could de facto end that estate's orderly wind-down.

The quantification of the maximum cumulative net liquidity outflow entails: (1) the daily netting of contractual inflows and outflows, (2) the incremental day-by-day aggregation of the daily net flow positions determined in step 1 starting from day 1, and (3) the determination of the maximum negative amount for any of the 180 days that results from the day-by-day aggregation in step 2. The amount determined in step 3 is the minimum amount of liquidity buffer cover assets required.

Regardless of the technical aspects mainly related to the unspecified or incorrectly specified day-by-day incremental aggregation of daily net liquidity positions for determining the day with the maximum aggregated negative position to avoid later inflows to offset earlier outflows, [383] the EBA analysis focused on the more substantial issue of the use of Article 16(5) of the CBD in conjunction with allowing 'objective triggers' that may become effective prior to a separation of estates.

11.2.5 CONCLUSIONS AND POLICY RECOMMENDATIONS

Overall, the EBA highlights that there is a strong rationale for covered bond investor protection to require a liquidity buffer based on the initial maturity date and to allow extension only after insolvency/resolution of the issuer. The liquidity buffer ensures that issuers prepare for the payment of obligations in advance. The insolvency/resolution of the issuer is an objective trigger, for which the absence of issuer discretion is clear, given that an issuer would avoid this situation at all costs. By allowing an extension only after insolvency/resolution, the legal framework gives more room for the special administrator, who then has the option to extend to meet the future payments linked to the wind-down of the issuing institution.

(383) Based on the assumption that any amount of payment obligation of the covered bond estate missed for any duration may initiate the termination of the estate's orderly wind-down.

Recommendation 23. *On the determination of the next 180 days' maximum cumulative net liquidity outflows.*

For determining the next 180 days' maximum cumulative net liquidity outflow as per Article 16(2) of the CBD, issuers shall proceed in three steps:

- *Net the daily contractual inflows and outflows.*
- *Accumulate incrementally the daily net positions determined under the previous step starting with day 1 until day 180.*
- *Use that day cumulative net liquidity position to calculate the necessary liquidity buffer for cover assets whose cumulative net liquidity position determined under the previous step results in the largest negative amount.*

Deviations by amount or time over which the netting under the first step is to be performed shall be permissible only, where statutory civil and insolvency law clearly states that non-payment of an amount due at the due date would not automatically constitute grounds for legal action by affected covered bond creditors against the covered bond estate.

Recommendation 24. *On the conditions to allow the discretion set forth in Article 16(5) of the CBD.*

Where maturity extension may occur prior to estate separation, the use of the discretion set forth in Article 16(5) of the CBD shall be allowed only if:

One of the following conditions is verified:

- *The objective relevant maturity extension triggers are consistent with the assumption underlying Article 16 (5) of the CBD that an issuer will be able to extend maturity whenever it will be unable to meet covered bond principal payment obligations as they fall due.*
- *The covered bonds are subject to match funding requirements, and the objective maturity extension trigger covers the situation of a failed refinancing of the bonds, ensuring that there is no net liquidity outflow before or after the refinancing.*

And one of the following additional conditions is met:

- *The covered bond issuer is participant in or beneficiary of an established scheme in which credit institutions of sufficient number and size are committed to undertake providing liquidity at fair value to an insolvent issuer's covered bond estate in exchange for transfer of or receiving a security interest in cover-eligible assets, and the purpose of and list of participants in such scheme is disclosed to the NCA.*
- *Where maturity extension occurs prior to estate separation and the liquidity buffer has been calculated based on the final maturity, the issuer should present to the NCA – upon or right after the extension – a plan on how they intend to rebuild the liquidity buffer 180 days in advance of the extended covered bonds' legal maturity, and document the potential effects that this plan can have on the LCR. This condition does not apply to match funding models.*

12. GREEN COVERED BONDS AND ESG RISKS OF COVER POOLS

KEY TAKEAWAYS OF THIS CHAPTER

GREEN COVERED BONDS AND ESG RISKS OF COVER POOLS

ESG disclosure is currently outside the scope of the EU covered bond framework. Institutions are required to report taxonomy alignment and climate risk metrics related to their overall balance sheet, but no information is required at the cover pool level.

The EBA is of the opinion that disclosing ESG related metrics at cover pool level is of particular importance for investors, because it can inform them of their risk exposure in the case of issuer default and subsequent separation of estate.

In analysing the issue and defining policy actions, the EBA adopted a cautious approach aimed at balancing the costs in terms of reporting burden and the benefits in terms of investor information. **The EBA recommends the scope of the disclosure to be limited to climate risk (transition and physical) of immovable property**, by means of a modification to the CBD to allow for this information to be added to the general covered bond disclosure provisions. To guarantee a proportionate approach, the EBA does not bring forward any indication as to the modalities of the disclosure, **the EBA recommends ESG disclosure on an annual basis, and only for the cover assets for which climate risk metrics are available**.

12.1 Introduction

The market for green covered bonds has been expanding substantially in the past five years, following a common trend among other types green of financial products. (384) Figure 29 reports the share of sustainable covered bonds issued over the total covered bonds issuance. (385) Data shows that issuance of sustainable bonds has been increasing considerably in relative terms, rising from 1.64% to 4.75% of total issues on a European aggregate basis from 2019 to 2022. (386)

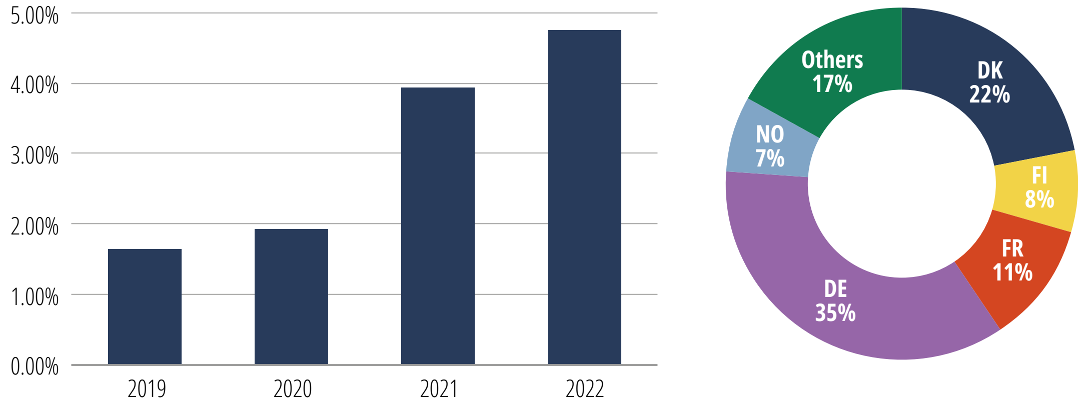
(384) More data on ESG can be found in Section 15.8.

(385) Sustainable covered bonds are defined here by ECBC as bonds from an issuer who commits to use an amount equivalent to the proceeds of that same covered bond to (re)finance loans in clearly defined environmental (green), social or a combination of environmental and social (sustainable) criteria. Of course, data reported here are to be intended as a mere overview, since this definition of sustainability comes from the alignment with the ECBC's HTT template, which by no means follows official EU criteria.

(386) In absolute terms, this translates to EUR 27 700 million issuance in 2022 in Europe, compared to EUR 8 250 million in 2019.

Still, Figure 29 (bottom) shows the distribution of issuance of sustainable covered bonds (as of 2022) among the European countries for which data is available, highlighting a very uneven picture, with five countries making up more than 80% of the total.

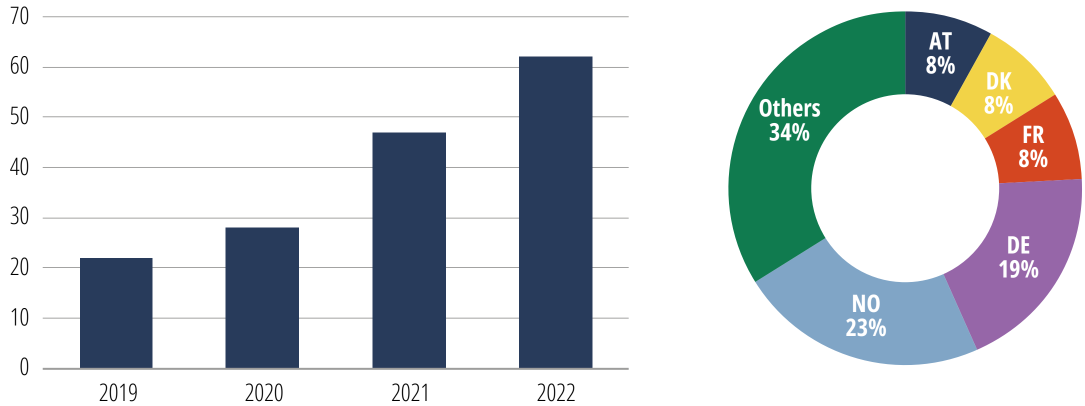
Figure 29: Issuance of sustainable covered bonds over total covered bonds issuance, Europe aggregate, percentage (top); share of outstanding sustainable covered bonds by country, 2022, percentage (bottom)



Source: EBA calculations based on ECBC data.

Moreover, more players in other European countries have entered the market of green covered bonds, in addition to early adopters like France, Germany and Norway. Figure 30 (top) reports the number of entities that issued green covered bonds in the given year. As to 2022, 62 institutions were issuing green covered bonds, compared to only 22 in 2019. If compared to the issuing amounts, issuing institutions are slightly more evenly distributed across European countries (bottom).

Figure 30: Number of institutions issuing sustainable covered bonds, Europe aggregate (top); breakdown by country,2022, percentage (bottom)



Source: EBA calculations based on ECBC data.

12.2 Policy background

In a joint statement dated March 2023 ([387]) the ECB and the ESAs expressed their intention to contribute – within their respective mandates – to the green transition of the financial sector. Within the framework on sustainable finance, the institution agreed to further enhance the disclosure of ESG financial products by issuers. Intervention will be particularly important in areas, which are not yet covered by the EU taxonomy and disclosure regulation, chiefly for structured financial products. This note will focus on ESG disclosure for covered bonds backed by real estate mortgages, which are the most relevant in terms of climate risk contribution. ([388])

In addition, within the context of the CfA, the EBA is asked to provide an overview of current developments and suggestions for a future introduction of ESG related risks in the CBD, considering interlinkages with the already existing Pillar 3 disclosure and the aforementioned joint statement.

Finally, in the context of the entry into force of the CRR III, the EP and the Council of the EU have requested to the EBA ([389]) to revise – within its mandate – the ITS on ESG disclosure. More specifically, to assess a means of enhancing the disclosure of ESG-related risks of cover pools of covered bonds and considering whether to include this information in the revised ITS, or in the regulatory and disclosure framework for covered bonds.

The growing interest of investors in the sustainable characteristics of covered bonds poses new regulatory challenges in terms of disclosure of the climate-related risks of these products. Moreover, because the typical underlying assets for covered bonds (mortgages) are also subject to climate risks, a need arises for investors to have more detailed and comprehensive data to inform their investment decisions.

The lack of disclosure at the cover pool level is also interlinked with taxonomy alignment. In absence of consistent disclosure data, institutional investors find it difficult to search for bonds whose characteristics are compatible with the sustainable investment strategy they would like to pursue. For the non-banking sector (mainly investment funds), the share of funds classified as per Article 9 of the Sustainable Finance Disclosure Regulation (SFDR) ([390]) is very low (4%), compared to Article 8 (55%) and Article 6 (41%) of the same Regulation. ([391]) Since Article 9 funds represent the funds who commit the most to sustainable investments, information on climate risks they would be exposed to at cover pool level in case of insolvency of the issuer is crucial to determine their viability. ([392])

12.3 The EU ESG disclosure framework

At present, covered bond issuers have the possibility to provide green and sustainable-related data in a standardised manner through the Harmonised Transparency Template (HTT), developed by the ECBC. This is a market-promoted framework designed to be fully compliant with Article 14 of the CBD and includes a section on sustainability disclosure. In particular, the HTT

([387]) See the Joint ESAs-ECB Statement on disclosure on climate change for structured finance products.

([388]) There is currently no agreement on how to treat covered bonds backed by public sector securities in terms of ESG risks, while covered bond backed by ship liens are a residual category in terms of size.

([389]) See Recital 55 of Note 15883/23.

([390]) Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability-related disclosures in the financial services sector (OJ L 317, 9.12.2019, p. 1, ELI: http://data.europa.eu/eli/reg/2019/2088/oj).

([391]) Source: ING calculations based on Morningstar data. In accordance with the SFDR, Article 9 funds ('dark green funds') are products that have sustainable investment as their explicit objective, while Article 8 funds ('light green funds') are products that promote environmental or social characteristics, but do not have sustainable investment as their sole objective.

([392]) Exposure to the underlying collateral derives from the dual recourse mechanism of the instrument.

offers the possibility to fill-in two templates (one for mortgages and one for public sector assets) disclosing information on the percentage of cover pool assets, which are classified as sustainable, accompanied by various breakdowns. ([393]) Of course, being a private market initiative, the template is compiled on a voluntary and best effort basis.

In January 2022, the EBA published the ITS on ESG disclosure for large institutions, including instructions to report qualitative and quantitative information on physical and transition risks, alignment with the EU Taxonomy Regulation, as well as the mitigation actions adopted. This disclosure package is known as Pillar 3. The key metrics of quantitative reporting are the Green Asset Ratio (GAR), reported in Templates 6 to 9 of P3, which measures the share of exposures aligned with the Taxonomy; ([394]) the Banking Book Taxonomy Alignment Ratio (BTAR), which assesses alignment of exposures towards non-financial corporates not subject to the Non-Financial Reporting Directive; exposures to sectors in geographical areas affected by climate change (physical risk, reported in Template 5 of P3), as well as carbon intensity and energy efficiency of counterparties and collateral (transition risk, reported in Template 2 of P3). The key metrics of qualitative reporting are information of governance, business model and strategy, ESG risk management for each category, and explanations of quantitative reporting. However, at present P3 disclosure does not allow to distinguish between unencumbered and encumbered assets and hence covered bonds.

In 2023, the EU adopted the European Green Bond Standard Regulation, ([395]) which offers bond issuers (of any type) a voluntary disclosure based on a threefold framework. First, a Green Bond factsheet to be completed prior to issuance, indicating the contribution of the instrument to the overall strategy of the institution; second, an Allocation Report to be released after the issuance, indicating how the proceeds have been allocated with respect to the EU Taxonomy; and third an Impact Report to be released after issuance, indicating the alignment of the bonds' environmental impact associated with the activities funded by the proceeds. If the bond meets the concept of use of proceeds to (re)finance green transition (for at least 85% of its value), it is assigned the EU green label. The concept of use of proceeds applies also to covered bonds: in this case, the funds received upon the sale of the instrument can be seen as re-financing the assets covering it. The extent to which there is re-financing to green activity would alone give some disclosure in terms of taxonomy alignment.

To put things in perspective, the ESG disclosure regarding similar structured finance products (e.g. securitisation) is already at a much more advanced level. In detail, as per transparency requirements of the Securitisation Regulation (SECR), ([396]) the originators, sponsors and SSPEs have to make available certain information on the underlying exposures, like the energy performance certificate (EPC) information. For STS securitisations, the disclosure of the EPC information is mandatory for those securitisations where the underlying exposures are residential loans or auto loans or leases. As per the Capital Markets Recovery Package Regulation which amended the SECR, the originators may decide to disclose only the available information related to the principal adverse impacts (PAI) of the assets financed by the underlying exposures on sustainability factors

([393]) Among the others, the type of the sustainable mortgage real estate (commercial, residential, and further breakdown) or of the sustainable government bond, the geographical breakdown, together with additional financial information of the underlying assets (such as maturity profile and alike).

([394]) Regulation (EU) 2020/852 of the European Parliament and of the Council of 18 June 2020 on the establishment of a framework to facilitate sustainable investment, and amending Regulation (EU) 2019/2088 (OJ L 198, 22.6.2020, p. 13, ELI: http://data.europa.eu/eli/reg/2020/852/oj).

([395]) Regulation (EU) 2023/2631 of the European Parliament and of the Council of 22 November 2023 on European Green Bonds and optional disclosures for bonds marketed as environmentally sustainable and for sustainability-linked bonds (OJ L, 2023/2631, 30.11.2023, ELI: http://data.europa.eu/eli/reg/2023/2631/oj).

([396]) Regulation (EU) 2017/2402 of the European Parliament and of the Council of 12 December 2017 laying down a general framework for securitisation and creating a specific framework for simple, transparent and standardised securitisation, and amending Directives 2009/65/EC, 2009/138/EC and 2011/61/EU and Regulations (EC) No 1060/2009 and (EU) No 648/2012 (OJ L 347, 28.12.2017, p. 35, ELI: http://data.europa.eu/eli/reg/2017/2402/oj).

using the templates (RTS on PAI disclosure for STS securitisation) developed by the JC of the ESAs on the sustainability-related disclosures for STS securitisations. ([397]). Even in the case of securitisation, a loan-by-loan disclosure can only be partial, raising the potential for greenwashing. It shall also be noted that since disclosure is currently at a loan-by-loan level, but on voluntary basis (for the PAI), it would be hard a push for prescriptive loan-by-loan disclosure on the cover pool, without making parallel progress on other structured finance products.

12.4 Insight from industry

From an issuer perspective, there is consensus that any change in the direction of cover pool level disclosure, while beneficial for transparency and hence attracting investment, would at present be challenging to implement. The main obstacle is the difficulty of gathering enough quality data on the ESG characteristics of the underlying assets. At the moment, issuers mainly rely on a wide range of metrics to assess greenness (and similar social and governance characteristics) of borrowers. These metrics, depending on the type of mortgage, include Energy Performance Certificates (EPC), GHG and CO_2 emissions, primary energy use, and others. Most of them are assessed by a third party such as external auditors and are often based on estimates. Disclosure at the cover pool level would require combining the metrics for all assets involved in the constitution of the cover pool, including those that do not meet any green requirements, and it would ultimately increase the supervisory burden. Respondents report that there are already enough instruments for disclosure purposes (the main one being the voluntary HTT). For the same reason, there is a certain scepticism about the introduction of an EU green label based on cover pool score.

On the other hand, investors welcome more transparency in ESG disclosure. There is a wide consensus that information available lacks harmonisation across jurisdictions and sometimes even within the same one, especially given the high number of metrics involved in assessing greenness (taxonomy alignment) and ESG-related risks. This view is shared by analysts and rating agencies. There is an overall agreement in advocating the introduction of cover pool level disclosure of both taxonomy alignment (DNSH, GAR and BTAR) and ESG-related risks (transition risk and physical risk), in addition to the existing use-of-proceeds, to grant full information on the assets they would be exposed to in case of insolvency. Transparency regarding the proportion of green assets in the cover pool is also particularly regarded given the presumed higher profitability of green collateral assets with respect to brown collateral assets, as the former are expected to benefit from higher demand.

Given the confusion from the large number of different metrics and certifications offered by issuers, ([398]) respondents advocate unanimously for more pragmatism, welcoming the introduction of a single EU green label based on a cover pool score.

Many respondents (especially issuers) pointed out the possibility of a grandfathering issue: as it is nearly impossible to gather data on the stock of outstanding collateral, especially for older mortgages, it is controversial whether a new disclosure at a cover pool level will be feasible from a technical point of view. Some issuers warn that this could result in a multi-tier covered bond market, due to differences in adoption of ESG principles between old and new collateral assets.

The introduction of disclosure of physical risks can be considered based on what is already available in the market. A few issuers estimate physical risks by classifying real estate in accordance with their location (geographical coordinates and administrative postcodes) and then assessing the likelihood of adverse climate-related events based on the area's records. It can be assumed that including this information in P3 Template 5 at a cover pool level will not be too cumbersome. Rating

([397]) The templates have been published in the Official Journal on 18 June 2024.

([398]) As an example, the usual ESG indicators are the following. For environmental assessment: EPC, CO_2, average water intensity, average waste intensity, recycling ratios; for social assessment: percentage of women employed, especially in management positions; for governance: board diversity and pay linked to green objectives.

agencies also advocate for disclosure of physical risk for a better rating assessment.

An important issue worth discussing is the harmonisation and comparability of the metrics involved in the assessment of ESG-related risks. If the goal is to provide the investor with a standard, transparent label of greenness of the cover pool that can be compared across the entire single market, underlying assets must be evaluated based on common criteria. Both issuers and investors lament the high number of metrics used within and across the countries and – even within the same metric – how differently it is defined across jurisdictions (e.g. the EPC). Of course, the divergence of calculation methods is an issue that pertains to the entire banks' balance sheet disclosure in P3, but ignoring the problem of comparability at the cover pool level would make a single EU green cover pool label useless.

12.5 Policy assessment

There are two main areas of intervention for policy development. First, the alignment of covered bond disclosure to the EU Taxonomy. Second, the introduction of disclosure requirements of climate-related risks at the cover pool level for all covered bonds.

As to the first point, the EBA recommends not to extend the scope of the taxonomy alignment framework to covered bonds, judging it not suitable nor informative for the purpose of disclosure at a cover pool level.

After analysing the opportunity of developing a dual framework, which combines both ITS Pillar 3 disclosure (including a breakdown for covered bonds and securitisation, which are source of asset encumbrance) and investor information under Article 14 of the CBD in a consistent fashion, ([399]) and in view of the political sentiment that followed the recent publication of the EC Omnibus on simplification, which also extends to reducing the number of items that need to be disclosed, as well as their level of detail, the EBA considers the route of modifying P3 disclosure not viable.

12.6 Conclusions and policy recommendations

Considering the above, the EBA does not recommend a specific disclosure modality in the CBD (in the form of an amendment of the CBD requiring issuers to provide investor information in the form of an ITS/P3), while instead adopting a more principle-based approach consistent with Article 14 of the CBD. This would entail including a requirement in the said Article to disclose climate risk related to cover assets whilst leaving the modalities to the transposition of that rule.

In bringing forward this recommendation, the EBA acknowledges the existence of a trade-off between the protection given to the investor by a more detailed and frequent disclosure, and the costs for the issuers to provide more information and has shaped its assessment in the spirit of proportionality.

([399]) In other words, this amount to introducing a provision in Article 14 of the CBD linking ESG disclosure to P3 reporting.

Recommendation 25. *On the disclosure of climate risk at the cover pool level.*

Having assessed the merits of a disclosure of climate risk at the cover pool level with the aim of informing the secured investor upon the risks to which they are exposed to in case of passage to the second recourse, the EBA recommends amending Article 14 of the CBD to include the relevant information. Having considered the need for a balance between investor protection and disclosure costs for the issuer, and in the spirit of regulatory simplification, the EBA recommends the following:

- *As to the required information, the introduction of a disclosure of the risks associated with those assets for which climate-related data (e.g. the EPC score) are available, paired with a measure of the coverage of data availability over the total of the pool. In this regard, the EBA acknowledges that mortgages related to immovable property for which climate-related data are not available will gradually phase out.*
- *As to the frequency of the provided information, an annual disclosure by way of derogation from the quarterly frequency rule provided for in Article 14 of the CBD.*

13. ALIGNMENT OF COVER ASSET ELIGIBILITY AND RISK TREATMENT UNDER THE CBD AND THE CRR

KEY TAKEAWAYS OF THIS CHAPTER

OVERVIEW

In reviewing the EU covered bond framework, the EBA has also developed a thorough analysis of the alignment of the said framework to the recently implemented credit risk framework of the CRR III, which transposed the new rules of the Basel III Accord. There are undoubted merits in looking for a higher degree of harmonisation between the two frameworks, both in terms of regulatory simplification (and subsequent reduction in the costs of compliance of the institutions) and a reduction of risks from a prudential perspective. There is also the fact that the CRR III generally has more stringent requirements than the CBD/Article 129 of the CRR for preferential risk treatment for the purpose of cover asset eligibility. The EBA identified three main areas of intervention.

Treatment of real estate under construction

There are important differences in the treatment of real estate under Basel III (which is almost entirely mirrored in the CRR III) and the EU covered bond framework in terms of cover asset eligibility. In accordance with the former, to be eligible for the preferential risk treatment, an immovable property must be finished, with the exception of small residential dwellings that are meant to become the primary residence of the borrower, and in case of involvement of a public authority with powers to ensure that the property will be finished. When it comes to eligibility for cover purposes, Member States apply heterogeneous provisions, with some already aligning to the CRR III, while others allow CRE under construction, or RRE that does not fall under the CRR III exceptions, or a mix of the two.

In the spirit of further simplification, as well as of a higher degree of protection to the covered bond investor that is guaranteed by a stricter selection of eligible assets, **the EBA recommends a full alignment between the two frameworks**, by means of a reference in Article 129 of the CRR (which regulates the preferential credit risk treatment for covered bonds) to Article 124(3) of the CRR (which transposes the preferential credit risk treatment of Basel III).

Valuation method of immovable property

Upon application of the CRR III, institutions have become obliged to apply prudent valuation for the purpose of the general credit risk framework, as prescribed by Article 229 of the CRR. At the same time, the CBD/Article 129 of the CRR still allow the use of market value. This difference in treatment is mirrored in national legislation, which is very heterogeneous when it comes to allowable valuation methods, with some Member States allowing only prudent valuation or mortgage lending valuation, some others market value, and some others both of them.

The EBA analysed in detail the merit of an alignment of the two frameworks. On one side, such an alignment to prudent valuation would set a further step towards the said regulatory simplification but would also shield the investor from the risks arising from excessive market fluctuations and, where two valuation methods are used, it would simplify its assessment of the risks to which he is exposed. At the same time, the EBA acknowledges that an imposed restriction on the use of market value may impact markets unequally, depending on traditional market practices and the covered bond model adopted, which can also translate in the sensitivity of LTV limits to valuation changes. For these reasons **the EBA, while reinstating the merit of a full alignment in the spirit of regulatory simplification, recommends to the COM to further assess the costs and benefits of such a change in regulation**.

Loans guaranteed by eligible protection providers

As an exception, the CRR III allows institutions to regard loans to natural persons that are guaranteed by eligible protection providers (in accordance with some technical criteria) as exposures secured by a mortgage on residential property for the purpose of the credit risk treatment. At the same time, the covered bond framework regulates such category of loans, with criteria that are close but distinct from those of credit risk. Considering also that the criteria for credit risk treatment do provide additional safeguards, **the EBA recommends aligning the requirements for this category of loans in the covered bond framework to the same requirements of the general credit risk provisions.**

13.1 Introduction

As part of the review of the EU covered bond framework, the EBA reviewed its alignment and the consistency with the general credit risk framework of the CRR III. More precisely, the analysis covered some of the most important aspects of this alignment, and namely the treatment of real estate under construction, the valuation methods for immovable property and the residential loans fully guaranteed by eligible protection providers. The goal of the analysis is to highlight sources of discrepancy and assess whether there is potential for harmonisation, and to what extent deviations are instead beneficial and advisable for different policy objectives.

13.2 Overview of the different frameworks

In Basel III, an exposure to covered bonds is defined as a standalone exposure class in the standardised approach to credit risk. In the Basel framework, covered bonds are required to be collateralised mainly by claims on public administrations or real estate, and to a lesser extent through claims on credit institutions.

In accordance with CRE20.34, in order to be eligible for the risk weights set out in CRE20.38, the underlying assets (the cover pool) of the covered bonds as defined in CRE20.33 shall meet the requirements set out in CRE20.37 and shall include any of the following:

- claims on, or guaranteed by, sovereigns, their central banks, public sector entities or multilateral development banks;
- claims secured by RRE that meet the criteria set out in CRE20.71 and with a loan-to-value ratio of 80% or lower;
- claims secured by CRE that meets the criteria set out in CRE20.71 and with a loan-to-value ratio of 60% or lower;
- claims on (or guaranteed by) banks that qualify for a 30% or lower risk weight. However, such

assets cannot exceed 15% of covered bond issuances.

In the EU covered bond framework, cover asset eligibility is regulated by Article 6(1) of the CBD, which allows three categories: (a) assets eligible under Article 129(1) of the CRR, (b) high quality assets that comply with specific safeguards and (c) loans to or guaranteed by public undertakings. The assets eligible under Article 129(1) of the CRR broadly correspond to the ones set out in the Basel framework, in terms of exposures to various forms of public administrations (Article 129(1)(a) and (b) of the CRR), of real estate (Article 129(1)(d), (e) and (f) of the CRR), and credit institutions (Article 129(1)(c) of the CRR). The main difference is the inclusion of loans secured by maritime liens on ships (Article 129(1)(g) of the CRR). For the types of assets other than the ones listed in Article 129(1) of the CRR, Article 6(1)(b) and (c) of the CBD, the CBD mainly target exposures that do not meet the additional requirements of this Article and other types of exposures on public undertakings.

In general, the Basel framework is more restrictive on the eligibility of collateral for covered bond purposes. The EU framework currently allows for more 'exotic' assets, such as the ones secured on 'maritime liens' under Article 129(1)(g) of the CRR or the exposures to public undertakings under Article 6(1)(c) of the CBD. Moreover, the 'high-quality cover assets' as per Article 6(1)(b) of the CBD target mainly mortgages, which are already covered under Article 129(1) of the CRR. Overall, cover assets allowed in the EU covered bond framework are not sufficiently defined in Article 6 of the CBD and are more heterogenous than the ones allowed within the Basel framework.

The largely dominant class of cover asset for covered bonds issued in the EU is real estate. In the Basel framework, to be eligible as cover assets, the immovable property shall meet the requirements set out to be classified as a 'regulatory real estate exposures' (CRE 20.71), including the ones on prudent valuation (CRE 20.74 to 76). Although many of these requirements are matched in the EU covered bond framework, Basel also sets up higher standards in the context of the eligibility of RRE under construction and on the use of prudent valuation. In detail, in the Basel framework immovable property is subject to the following requirements (as per CRE 20.71): (a) the property must be finished (with limited exemptions), (b) the bank should have a legal enforceable claim, (c) this claim should be a senior claim on the property (or equivalent mechanism), (d) the bank should have performed an assessment of the borrower's ability to repay, (e) the property is subject to prudent valuation and (f) the banks should have adequate documentation.

At the same time, it shall be noted that there are other aspects where the EU framework is more stringent than the Basel Standards, such as on the monitoring of the value of the property (annually at least) and on the requirement to monitor that physical collateral is adequately insured against the risk of damage (Article 6(6) of the CBD, as is reinforced by Article 208(5) of the CRR by way of Article 129(3) of the CRR).

In tandem with the introduction of prudent valuation in the credit risk framework, the CRR III introduced for immovable property collateralising covered bonds only a subsection of the corresponding requirements. While leaving the general valuation rules for immovable properties to national discretion in accordance with Article 6(5) of the CBD, the CRR III introduced a cap on value increases of the property as per the added subparagraph of Article 129(3) of the CRR, giving power to the covered bond-competent authorities to exempt from it. This means that under the current CRR III market value may still be used for immovable properties in the context of coverage requirements, if the NCA allows for it. Otherwise, NCAs would have to require that institutions under their supervision apply the full set of prudent valuation as per Article 229 of the CRR (i.e. on top of the application of the cap on the valuation) for the valuation of immovable property for coverage purposes.

Overall, the Basel framework sets out strict requirements for immovable properties collateralising covered bonds, which are identical to the ones in the credit risk framework. In the CRR III, the Basel framework has been translated for the requirements on immovable properties, although in a slightly less stringent form. In this regard, the requirements on the eligibility of immovable property, such as cover assets, remained largely untouched and are now significantly less stringent than what is required in the credit risk framework.

In this context, there is rationale to improve the consistency between credit risk requirements and coverage requirements in the CRR III and the CBD. The main objective is to ensure the highest quality of cover assets for 'European Covered Bond (Premium)' bonds. This would also favour a closer alignment to Basel requirements, as well as a simplification of the regulatory requirements for covered bonds issuers. These improvements are recommended in three areas: treatment of real restate under construction, property valuation, and guaranteed loans.

13.3 Real estate under construction for coverage requirements

13.3.1 INTRODUCTION AND LEGAL REFERENCE

Unlike Basel, at present the EU covered bond framework does not reserve a particular treatment to the sub-category of real estate assets known as real estate under construction. As such, this sub-category is considered eligible as a cover asset under Article 129(1)(d) and (f) of the CRR. This eligibility is a source of discrepancy within the general framework, since in Basel these assets are explicitly excluded. Indeed, the Basel framework specifies that claims secured by RRE and CRE shall meet the eligibility criteria set out in CRE 20.71 to be considered real estate from a regulatory point of view, including the requirement that the property is completed, with two exemptions. A comparison of the main requirements for the use of real estate under construction under the two frameworks is reported in Figure 31.

Figure 31: Main requirements for the general credit risk treatment of real estate under construction in Basel and in the CRR III ([400])

CRE 20.71	CRR III credit risk framework, Article 124(3)(a)
Finished property: The exposure must be secured by a fully completed immovable property. This requirement does not apply to forest and agricultural land. Subject to national discretion, supervisors may allow this criterion to be met by loans to individuals that are secured by residential property under construction or land upon which residential property would be constructed, provided that: (i) the property is a one-to-four family residential housing unit that will be the primary residence of the borrower and the lending to the individual is not, in effect, indirectly financing land acquisition, development and construction exposures described in CRE20.90, or (ii) sovereign or PSEs involved have the legal powers and ability to ensure that the property under construction will be finished.	The immovable property securing the exposure meets any of the following conditions: (i) the immovable property has been fully completed; (ii) the immovable property is forest or agricultural land; (iii) the lending is to a natural person and the immovable property is either a residential property under construction or it is land upon which a residential property is planned to be constructed where that plan has been legally approved by all relevant authorities, as applicable, and where any of the following conditions is met: (1) the immovable property does not have more than four residential housing units and will be the primary residence of the obligor and the lending to the natural person is not indirectly financing ADC exposures; (2) a central government, regional government or local authority or a public sector entity is involved, exposures to which are treated in accordance with Article 115(2) or Article 116(4) of the CRR, respectively, and has the legal powers and ability to ensure that the property under construction will be finished within a reasonable time frame and is required, or has committed in a legally binding manner, to ensure completion where the construction would otherwise not be finished within such reasonable time frame; alternatively, there is an equivalent legal mechanism in place to ensure that the property under construction is completed within a reasonable timeframe.

([400]) There are no such requirements in the covered bond framework.

13.3.2 POLICY ANALYSIS

The stricter Basel requirements have been transposed in the CRR III credit risk framework and chiefly in Article 124 of the CRR. However, the CRR III also allows for the two aforementioned exemptions: (1) the immovable property does not have more than four residential housing units, it will be the primary residence of the obligor, and the lending to the natural person is not indirectly financing ADC exposures (Article 124(3)(a)(iii)(1) of the CRR), and (2) there is an involvement of a central or regional government, or a local authority or a public sector entity, that has the legal power to ensure that the property under construction will be completed within reasonable time or, alternatively, there is an equivalent legal mechanism in place (Article 124(3)(a)(iii)(2) of the CRR). Unless they meet one of these two exemptions, exposures secured on real estate under construction assets are considered as unsecured and are thus subject to higher risk-weights.

In addition to those applied to real estate under construction, Article 124 of the CRR sets stricter requirements for real estate assets that have been already been completed, the most important of which are that: (1) the exposure is secured by a first lien by the institution on the property (or the institution holds the first lien and any subsequent ones) (Article 124(3)(b)), and (2) the property value is not materially dependent upon the credit quality of the obligor (Article 124(3)(c)). The EBA acknowledges that these requirements are also a source of discrepancy between the two frameworks.

In addition to this discrepancy of treatment, there is a certain degree of heterogeneity among jurisdictions on the interpretation of which exposures can classify as 'loans secured by residential property' (RRE) and 'loans secured by commercial immovable property' (CRE). As a consequence, there are a few countries (Germany, Greece, Poland) that allow the inclusion of CRE under construction in the cover pool, and in some cases restrictions on the share of cover assets they may represent. [401] Others (Belgium and Spain) apply, for the purpose of cover assets, the interpretation of the EBA Q&A 2015_2304 on the conditions to be applied for residential property under construction. [402] Other countries do not specify which approach they follow.

13.3.3 CONCLUSIONS AND POLICY RECOMMENDATIONS

From a prudential perspective, there is a strong rationale for applying the CRR III credit risk requirements. From a regulatory perspective, Basel has set these requirements not only for covered bond purposes but also for these assets to be considered secured real estate exposures. From a more substantial perspective, assets covering 'European Covered Bond (Premium)' bonds should be of the highest quality, which may not necessarily be the case for real estate under construction.

Following this principle, the EBA is of the opinion that real estate under construction shall not be allowed for the purpose of coverage for 'European Covered Bond (Premium)' bonds, with the two exceptions granted by Article 124 of the CRR. As a consequence, CRE under construction will be excluded entirely.

At the same time, the EBA acknowledges that in some jurisdictions where real estate under construction is currently allowed in the cover pool (albeit with strong limitations), a full exclusion may have unwanted consequences if properties for residential purposes are in short supply (i.e. multi-family houses of more than four dwellings and/

(401) For instance, in Germany, real estate under construction is subject to limits of 10% for property not yet capable of producing income, with a further sub-limit of 1% for building land. Further, the mortgage-lending value of property under construction has to reflect the degree of completion.

(402) See the EBA Q&A 2015_2304 Risk weighting under standardised approach of an exposure secured by mortgage on residential property being constructed by the borrower (self-build) during the period of construction: 'This excludes situations where residential property 'may' be built in the future (i.e. mortgages on land) but includes mortgages on building sites on which residential property will be built for the future owner of the property, or on residential property under construction, provided in both cases that there is certainty that the owner will occupy or let the property. In this sense, the 35% risk weight cannot be applied to exposures towards real estate developers. […] This treatment does only apply to exposures fully and completely secured by mortgages on residential property, and not where units were to be exploited commercially.'

or RRE bought for purposes other than primary residence, for instance buy-to-let). This may be seen as creating a distortion in the housing market in terms of both supply and prices. However, the EBA, after having carefully considered the pros and cons of such a change, is of the opinion that the market impact will not be relevant, also in view of the strong limitations set by national legislations on the use of such assets and that a supply shortage of lesser quality assets may at the same time reduce negative spillover to the risk associated with buildings for permanent residential purposes under construction.

In view of the above, the EBA has formulated the following recommendation.

Recommendation 26. *On the eligibility of real estate for preferential risk treatment purposes.*

The EBA recommends an alignment to the CRR III credit risk framework, by means of including a reference to Article 124(3) of the CRR in the list of immovable properties eligible as cover assets for the label of 'European Covered Bond (Premium)' in Article 129 of the CRR. Consequently, exposures secured by immovable property that do not meet the conditions of Article 124(3) of the CRR (without any prejudice to the discretions provided for in the Article) and are considered unsecured for the determination of their risk weight (equal to either 75% or 100%) or classify as ADC (acquisition, development, and construction exposures, with a risk weight of either 100% or 150%), will be excluded from the scope of eligibility.

13.4 Property valuation

13.4.1 INTRODUCTION AND LEGAL FRAMEWORK

Among the changes introduced by the CRR III, the valuation principles for immovable property have important implications for the EU covered bond framework. In details, Article 229 of the CRR has introduced the concept of the prudent valuation for the purpose of the assignment of the risk weight. In contrast, the CBD still allows the use of the (less strict) market value for the purpose of eligibility as cover assets. ([403]) The use of the more conservative prudent valuation has created an additional discrepancy between the two frameworks. A comparison of the main requirements for the valuation of immovable property under the different frameworks is reported in Figure 32.

([403]) A third, more conservative method, the Mortgage Lending Value (MLV), is also permitted by the CBD, and it is the only one allowed by the Pfandbrief regulation in Germany.

Figure 32: Main requirements for the valuation of immovable property for cover assets in Basel, for general credit risk purposes in the CRR III and for 'European Covered Bond (Premium)' label

Basel CRE 20.74/20.75, applying both for credit risk and coverage purposes	CRR Credit risk framework, Article 229	Covered Bonds requirements for valuation, Article 6(5) of the CBD and Article 129(3) of the CRR
The value of the property will be maintained at the value measured at origination, with the following exceptions [...] (2) Value of the property: The valuation must be appraised independently using prudently conservative valuation criteria. To ensure that the value of the property is appraised in a prudently conservative manner, the valuation must exclude expectations on price increases and must be adjusted to take into account the potential for the current market price to be significantly above the value that would be sustainable over the life of the loan. National supervisors should provide guidance setting out prudent valuation criteria where such guidance does not already exist under national law. If a market value can be determined, the valuation should not be higher than the market value.	The valuation of immovable property shall meet all of the following requirements: (a) The value is appraised independently from an institution's mortgage acquisition, loan processing and loan decision process by an independent valuer who possesses the necessary qualifications, ability and experience to execute a valuation. (b) The value is appraised using prudently conservative valuation criteria which meet all of the following requirements: (i) the value excludes expectations on price increases; (ii) the value is adjusted to take into account the potential for the current market value to be significantly above the value that would be sustainable over the life of the loan. (c) The value is documented in a transparent and clear manner. (d) The value is not higher than a market value for the immovable property where such market value can be determined. (e) Where the property is revalued, the property value does not exceed the average value measured for that property, or for a comparable property over the last six years for residential property or eight years for commercial immovable property or the value at origination, whichever is higher.	Member States shall lay down rules on the methodology and process for the valuation of physical collateral assets which secure assets as referred to in points (a) and (b) of paragraph 1. Those rules shall ensure at least the following: (a) for each physical collateral asset, that a current valuation at or at less than market value or mortgage lending value exists at the moment of inclusion of the cover asset in the cover pool. (b) for each physical collateral asset, that a current valuation at or at less than market value or mortgage lending value exists at the moment of inclusion of the cover asset in the cover pool. For immovable property and ships collateralising covered bonds that comply with this Regulation, the requirements set out in Article 208 shall be met. The monitoring of property values in accordance with point (a) of Article 208(3) shall be carried out frequently and at least annually for all immovable property and ships. For the purpose of valuing immovable property, the competent authorities designated pursuant to Article 18(2) of Directive (EU) 2019/2162 may allow that property to be valued at or at less than the market value, or in those Member States that have laid down rigorous criteria for the assessment of the mortgage lending value in statutory or regulatory provisions, at the mortgage lending value of that property, without applying the limits set out in Article 229(1), point (e), of this Regulation.

13.4.2 POLICY ANALYSIS

In the current framework, the valuation requirements for immovable property collateralising covered bonds are set up by Member States in accordance with Article 6(5) of the CBD. As a consequence, there is a high degree of heterogeneity in the strictness of the valuation criteria adopted, which has been confirmed by the information collected via the questionnaire addressed to the NCAs.

For instance, Germany, Hungary, Spain and Poland apply the very conservative mortgage lending valuation (MLV) methodology, Belgium already applies prudent valuation, while Czechia, Denmark, Estonia, Finland, France, Greece, Italy, Lithuania, Sweden and Slovakia apply market value. There are also some countries (Austria, Bulgaria, Cyprus, Luxembourg, Portugal, Netherlands, Romania and Slovenia) that allow both market value and mortgage lending value. [404]

[404] Ireland applies n hybrid approach referred to as prudent market value (PMV) valuation.

In addition, Czechia, Germany, Portugal and Poland allow for prudent valuation as per Article 229 of the CRR, but only for CRR purposes (risk-weighting of the exposure). In contrast, all other countries (Austria, Belgium, Bulgaria, Cyprus, Denmark, Estonia, France, Greece, Finland, Hungary, Ireland, Italy, Lithuania, Netherlands, Romania, Slovenia, Slovakia, Spain and Sweden) use the same valuation method for CRR and covered bond purposes.

It is easily understandable that in this context, it may be difficult for investors to compare between the quality and the risks of two cover pools in two Member States.

The EBA analysed the merits of aligning the two methods (i.e. having the same valuation methodology for both the credit risk framework and the constitution and monitoring of the cover pool). For covered bonds, valuation is crucial to calculate the loan-to-value ratio that is necessary for the purpose of asset eligibility/coverage contribution. It should be highlighted that a possible decrease in the valuation due to the application of the prudent valuation methodology does not induce a reduction in the collateralisation, but rather a reduction in the amount of the eligible amount for collateralisation. ([405]) However, the actual impact of the application of prudent valuation for immovable property is difficult to estimate precisely, due to the underlying assumptions regarding property market developments.

In principle, prudent valuation increases the time that must elapse for issuers to benefit from increases in the market value of the property by automatically increasing the amounts of eligible loans included in the calculation of the coverage ratio. This is because loans secured by residential and commercial property that are part of cover pools are subject to a maximum loan-to-value ratio, based on the value of the property (80% for residential property – Article 129(1)(d) of the CRR and 60% for commercial property – Article 129(1)(f) of the CRR). In the event of the application of prudent valuation, an upward pressure in housing market prices would pass through more slowly to the value of the cover pool, reducing the risk associated with a market reversal.

There are undoubtedly advantages in full alignment: prudent valuation hedges against market fluctuations and ultimately contributes to investor protection. In addition, it would level the playing field across Member States by moving towards a higher level of harmonisation across national jurisdictions. Lastly, harmonising valuation methodology would also respond to the need for regulatory simplification and bring clarity to legal definitions. Indeed, because issuers are already obliged to adopt prudent valuation for credit risk purposes, applying the same methodology for coverage requirements will help to reduce the accounting burden, as well as to avoid the risk of a double standard. The potential impact also seems, by definition, commensurate with the risk, since a large departure from the market value means de facto that the market value is significantly above the value that would be sustainable over the life of the loan.

However, there are also some caveats to consider. Depending on the gap between market and prudent valuation, a sudden switch between the two methods may prompt issuers to have to add to the cover pool to stay in line with the required or market-expected levels of collateralisation. Clearly, the consequences will be more severe the higher is the resulting delta between the two valuations, as would be the implied risk of remaining on the weaker valuation methodology. In addition, a reduction in the value of the property may hit the (reduced) LTV limit for eligibility, lowering the current levels of over-collateralisation. Issuers will also be likely to increase the amount of assets collateralising covered bonds in order to match this reduction in over-collateralisation, therefore augmenting total asset encumbrance.

In other words, this change may ultimately result in an increase in coverage requirements, which would have the natural consequence of a general rise in interest rates, and possibly a restriction on market supply in some jurisdictions, depending on the market practices adopted for mortgage lending.

([405]) For instance, for loans secured by residential property, the coverage contribution is calculated as the lesser of the principal amount of the liens that are combined with any prior liens and 80% of the value of the pledged properties.

Beyond these general considerations, it appears that the change in the regulation may impact Member States unequally. For instance, in some countries where the funding of real estate mortgages is performed (almost) exclusively by covered bonds, banks do not have the possibility to wait for the amortisation of the assets, so they meet a given LTV target. This means that, in cases where these banks want to issue 'European Covered Bond (Premium)' bonds (i.e. covered bonds eligible in accordance with Article 129 of the CRR), there is a direct link between the maximum loan to value set in the regulation, and the maximum LTV they can provide as part of their commercial policy.

The EBA also acknowledges that, in practice, the CRR already applies by default the cap on the valuation of immovable properties for 'European Covered Bond (Premium)' bonds in those countries where the NCA did not take a decision to exempt the issuers from it. Given this, one would not expect any strong market disruption because of the cap, indicating that the risks on financial stability of the transition should not be overestimated. However, the effect of the application of the cap may differ across jurisdictions, especially in the cases where the level of over-collateralisation is already relatively low because of the applicable regulation or because of the more general covered bonds models. In other words, the transition may have, in some circumstances, a direct impact on the commercial practices of some banks in some specific jurisdictions, also depending on the covered bond model adopted.

Another argument in favour of market value is the high degree of transparency for both the borrowers and the investors. For borrowers, it is relatively easier to understand that a potential loan can be taken at 80% or 60% (depending on the LTV limits) of the trading price of the property, especially in countries with a specialised institution model, where it is always clear by definition that the loan will be funded by issuing covered bonds. This transparency would be hindered by a reduction of market value due to the methodology required by prudential valuation. For investors, the transparency of market value – paired with the fact that there is a certain degree of heterogeneity in the application of the aforementioned methodology across Member States – makes the state of the cover pool clearer, making it easier to calculate risks and therefore also the risk premium. Market value reflects real-time conditions, providing a clearer picture of the cover pool's health at each point in time.

Finally, in some Member States market value is a valuation method with a long-standing tradition, ([406]) and an alignment to prudential value may require an important change of their national legislation.

13.4.3 CONCLUSIONS AND POLICY RECOMMENDATIONS

Having informed the discussion with the explanation of the various pros and cons, the EBA recommends the following:

([406]) This is for instance the case in Denmark, where the covered bond model adopted entails specialised institutions that adopt a match-funding principle, according to which issued mortgages have to be matched almost one-to-one with covered bond issuances. As a result, assets and liabilities of these institutions are almost exclusively composed of granted loans and issued covered bonds, respectively.

Recommendation 27. *On the valuation method for immovable property.*

The EBA has analysed the pros and cons regarding the possibility to align the valuation method for the purpose of the eligibility of immovable property as cover assets, to the prudent valuation for the purpose of credit rick as per Article 229 of the CRR.

While the EBA is of the opinion that a full alignment to the CRR III will be in the spirit of regulatory simplification and clarity, as well as prudence, it also acknowledges that such a *transition may impact unevenly on the different EU jurisdictions depending on the covered bond models and the traditions in the market practices adopted in the different Member States*

In view of the above, the EBA recommends the COM to further analyse the implications of a policy change in the direction of this alignment.

13.5 Residential loans fully guaranteed by eligible protection providers

13.5.1 INTRODUCTION

The CRR III allows institutions to regard loans to natural persons as exposures secured by a mortgage on residential property, instead of being treated as guaranteed exposures, subject to stricter conditions. This new framework has been originally designed from the covered bond framework (Article 129(1)(e) of the CRR), but now new provisions of the CRR III have introduced stricter requirements for what concern their treatment under the credit risk framework.

Consequently, if there will be an alignment on the eligibility criteria for cover assets to the credit risk framework regarding RRE under construction and property valuation, these additional requirements would be useful to take on board. Indeed, the conditions set out for the treatment of such exposures, as exposures secured by a mortgage on residential property, instead of being treated as guaranteed exposures, are very comprehensive (Article 108(4) and 108 (5) of the CRR). Inspired by Article 129 of the CRR, Article 108 of the CRR sets the out conditions on both the national level and the level of individual exposures.

13.5.2 POLICY ANALYSIS

Article 108(4) of the CRR sets out conditions at the national level. First, NCAs shall inform the EBA on whether the majority of loans to natural persons for the purchase of residential properties in their jurisdiction are not of the form of mortgages but are instead guaranteed by protection providers with at least a CQS 2, as per Article 2021 of the CRR. This situation is mainly a French specificity, as in France guaranteed loans are a well-established practice, which has shown to be prudentially sound.

Second, the NCA shall provide the names of the protection providers eligible for the treatment, provided that the exposure meets all the requirements of an 'exposure secured by mortgages on immovable properties' in either the SA or IRBA, respectively. For this treatment to apply, there shall be no liens on the residential property. Additionally, the protection provider shall be an institution or a financial sector entity subject to own funds requirements comparable to those applicable to institutions or insurance undertakings. Finally, the protection provider shall have established a fully funded mutual guarantee fund (or equivalent), the calibration of which is periodically reviewed by its competent authority and is subject to periodic stress testing.

With respect to cover assets, Article 129 of the CRR currently allows residential loans guaranteed by an eligible protection provider, with conditions similar to those set by Article 108 of the CRR, which explicitly restricts the use of these cover assets to France. They differ mainly on three points: (a) the formal requirement on an analysis of the market at a national level, (b) the stress-testing requirements for the protection provider, and (c) the publication of the list of eligible protection providers by the EBA. Lastly, the credit risk framework is also more stringent in that it requires that the residential guaranteed loans meet all the requirements for mortgages under either the SA or IRBA (which is not a requirement in the current covered bond framework).

Overall, the difference between the two frameworks is substantial, and this calls for an alignment of the conditions on consistency and prudential grounds. Indeed, given that cover assets should be of the highest quality, they should not be subject to lower requirements than those that apply under the credit risk framework. Therefore, the EBA is of the opinion that Article 129 of the CRR shall be amended to reflect the conditions for residential guaranteed loans set out in Article 108(4) and 108(5) of the CRR. This change shall follow a grandfathering approach and hence apply only to new issuances.

13.5.3 CONCLUSIONS AND POLICY RECOMMENDATIONS

In view of the above, the EBA intends to bring forward the following recommendation:

Recommendation 28. *On the use of the asset category of loans fully guaranteed by eligible protection providers.*

In view of the specificities of the asset category of loans fully guaranteed, the EBA recommends a modification of the text of Article 129(1)(e) of the CRR to align the covered bond framework with the conditions set out in Article 108 of the CRR, which regulates the said instrument under the credit risk framework.

14. TREATMENT OF COVERED BONDS IN THE PRESENCE OF A DEFAULTED ISSUER

KEY TAKEAWAYS OF THIS CHAPTER

TREATMENT OF COVERED BONDS IN THE PRESENCE OF A DEFAULTED ISSUER

As part of its review of the EU covered bond framework, the EBA has identified an inconsistency in the treatment of covered bonds in the presence of a defaulted issuer. The issue arises from the provisions set out in Article 127 of the CRR on the classification of the exposures of the defaulted issuer (which does not specifically regulate covered bonds), which should be applicable to all unsecured parts of any items where the issuer has defaulted.

Although there are reasons for cover assets to be treated akin to unsecured exposures (i.e. because of the passage from first to second recourse and the subsequent loss of dynamic properties of the pool), the equalisation of covered bonds to unsecured exposures creates an unlevel playing field among different liabilities. For this reason, **the EBA** is of the opinion that this inconsistency shall be investigated further and **requests the COM to provide a mandate to review the matter in the future to bring proposals for possible amendments to the level 1 text**, while at the same time confirming that the provisions of Article 127 of the CRR shall still fully apply to covered bonds for the time being.

14.1 Introduction

There is no controversy upon the fact that the prudential treatment of covered bonds is intended to reflect the dual recourse of the instrument and, therefore, the creditworthiness of the issuers and the protection provided by the (over-collateralised) cover pool of certain eligible assets (in most cases composed by high quality mortgages). Due to these specificities, a dedicated framework has been introduced to recognise the risk reduction offered by the cover pool, both under the IRB and the Standardised Approach to assign the risk weight. Under the former, the status of high quality assets composing the cover pool justifies a more favourable treatment in the application of the LGD and PD input floors as per Article 161(1)(d) and Article 153 of the CRR, respectively. Under the latter, the risk weight is assigned in accordance with the rating of the instrument or – absent this – linked to that of the issuing credit institution as per Article 129(4) and 129(5) of the CRR.

However, in cases of default of the issuer, the treatment of covered bonds under the CRR, i.e. namely whether they should be considered defaulted unsecured exposures as per Article 127 of the CRR or they should still benefit from the favourable treatment as per Article 129 of the CRR, is controversial.

14.2 Policy assessment

From a risk perspective, in case of insolvency of the issuing bank the primary recourse would shift from the direct claim on the issuer to a claim on the proceeds of the cover pool (and to the issuer's insolvency estate for any loss remaining after the depletion of the cover pool). Additionally, in the presence of a defaulted issuer, the cover pool will lose its dynamic properties (no replenishment, no removal of defaulted cover assets, no active management of market risk exposures of the covered bond estate, etc.) and ultimately the possibility to maintain its quality. Finally, the application of additional secondary safeguards (e.g. liquidity buffers) in cases of insolvency is currently uncertain in the CBD. In view of this, one could claim that the second line of recourse is de facto undermined by the prudential default of the issuer, therefore questioning the applicability of Article 129 of the CRR.

From a legal perspective, the treatment of covered bonds with a defaulted issuer seems to be a grey area in the CRR. On the one hand, Article 127 of the CRR explicitly states that the provision should apply to any item where the issuer has defaulted and, in addition to this, both the classification of exposures set out in the ITS on supervisory reporting and the consistency with the IRB approach seems to reinforce this assumption. However, conversely, Article 127 of the CRR specifies that only the unsecured part of such items shall be treated as defaulted, and either refers to the CRM provisions of Chapter 4 of the CRR for the secured part or lays down an ad hoc treatment in the case of exposures secured by mortgages on immovable property, which are both not applicable to covered bonds.

As a final remark, it is important to note that the current legal uncertainty that follows from the strict interpretation of Article 127 of the CRR creates an unlevel playing field in the EU market, since the treatment of cover assets upon prudential default of the issuer can vary depending on the covered bond model adopted. For instance, models that adopt specialised institutions (as in France), would never be affected (as the specialised institution will be shielded from the default of the parent bank) and will continue to apply Article 129 of the CRR, while models that use universal banks (as in Germany) would suffer from the application of Article 127 of the CRR in case of issuer default, even though in both cases the first line of recourse would be likely equally lost.

14.3 Conclusions and policy recommendations

The EBA, having acknowledged that the application of Article 127 of the CRR is not fit for purpose, wishes to flag the issue as part of the response to the CfA. The conclusion is motivated by the fact that having a common understanding – among EU supervisors – on the prudential treatment for covered bonds in case of a defaulted issuer is a relevant aspect for the functioning of the EU covered bond framework.

In addition, the EBA, acknowledging that this issue could not be solved outside the level 1 text (e.g. via a Q&A), is of the opinion that the response to the CfA could serve the purpose of requesting a revision of Article 127 of the CRR, and hence brings forward a request for a separate mandate from the Commission. Until then, the EBA concluded that the provisions laid down in Article 127 of the CRR shall continue to apply.

15. THE EU COVERED BOND MARKET

15.1 Introduction

As part of the response to the CfA, the EBA has produced a detailed quantitative analysis on the performance and functioning of EU covered bond market. This analysis considers the average levels and main market trends, together with an assessment of the volumes of covered bonds eligible for the preferential risk weight treatment, the level of over-collateralisation, the level of issuances in the securitisation market, the yields for covered bond holders in recent years, the liquidity of covered bonds, the investor base, the number of permissions to issue covered bonds, and the contribution of covered bonds to the levels and trends of asset encumbrance.

15.2 Data sample

The analysis relies on different data sources. Asset encumbrance reporting data relies on a sample of 2 748 banks within the highest level of consolidation in the EU (used for the data based on a consolidated basis) and 3 323 solo entities (used for the data based on an individual basis). Additional information by country is provided in Figure 73.

15.3 EU banks covered bond liabilities and contribution of covered bonds to asset encumbrance

As of December 2024, EU/EEA banks report that covered bonds represent 6.4% of their total balance sheet ([407]) (8.3% when considering only covered bond issuers), as shown in Figure 33. Based on individual reporting data, ([408]) covered bonds represent 8.1% of the balance sheet (15.3% when considering only covered bond issuers), as shown in Figure 36. The share based on individual reporting is higher than that based on consolidated reporting because the EU banks issue more covered bonds in relation to their balance sheets than their subsidiaries located in other third country markets.

As of December 2024, the asset encumbrance ratio stood at 22.6% (24.7% when considering only covered bond issuers). ([409]) For both the total sample and for covered bond issuers, asset encumbrance ratios have steadily declined since the maximum level observed in June 2022 (Figure 37). The decline of the total amount of liabilities that are a source of encumbrance explain this decline.

This decline is explained by the drop of TLTRO funding that disappeared almost entirely as of December 2024, followed by a decline in central bank repos. Around 42% of this central bank funding has been replaced by other liabilities which

([407]) Carrying amount of covered bond liabilities (row 40, column 20 of F 35.00.a) divided by the sum of encumbered assets (row 10, column 10 of F 32.01) and unencumbered assets (row 10, column 60 of F 32.01).

([408]) The metric based on individual reporting excludes covered bonds issued by EU banks' subsidiaries on the numerator and excludes the assets of those subsidiaries in the denominator.

([409]) The asset encumbrance ratio is calculated in accordance with the formula reported in the EBA Rish Dashboard of Q3 2023 (p. 44, table of the formulas or risk indicators included in the Dashboard).

are source of encumbrance. The liabilities that are source of encumbrance that replaced central bank funding are traditional repo funding and covered bonds. Traditional repos replaced 27% of central bank funding while covered bonds replaced 12%. The explanatory power of covered bond funding in the evolution of the asset encumbrance ratio is limited, as covered bond funding is the second source of encumbrance as of December 2024 and represents 22.9% of the liabilities, while other deposits (e.g. repo funding) are the main source with a share of 43.2% of the liabilities (Figure 38). As of June 2022, covered bond funding was the third main source of encumbrance, after other deposits and TLTRO funding.

The limited capacity of covered bonds to explain the asset encumbrance ratio is visible in the recent evolution, as the increase in covered bond funding was not enough to maintain the asset encumbrance ratio and avoid its downward evolution. The increase in covered bond funding observed since the end of the COVID-19 pandemic only replaced 12% of the decline of TLTRO funding. Other sources of encumbrance, such as other deposits (e.g. repo funding) showed a higher increase compared to covered bond funding and remained as the main source of encumbrance. As mentioned above, the increase of both covered bond funding and other deposits only compensated 42% of the decline of TLTRO funding. Thus, the total amount of liabilities that explain encumbrance declined and pushed down the asset encumbrance ratio.

Figure 33: Covered bond liabilities as a share of total assets and as a share of total liabilities that are source of encumbrance, December 2024, consolidated reporting data

	CB liabilities/total assets		CB (% total liabilities that are source of encumbrance)		Asset encumbrance ratio		CB/total assets	
Country	**Tot sample**	**CB issuer**	**Total sample**	**CB issuer**	**Tot sample**	**CB issuer**	**Tot sample**	**CB issuer**
AT	9.4%	11.4%	57.9%	59.2%	19.5%	19.3%	16.1%	19.5%
BE	4.4%	4.7%	29.7%	29.9%	13.0%	13.7%	7.1%	7.6%
BG	0.0%	-	0.0%	-	3.8%	-	0.0%	-
CY	0.0%	-	0.0%	-	7.4%	-	2.0%	-
CZ	0.0%	-	0.0%	-	5.1%	-	0.0%	-
DE	4.0%	7.5%	13.6%	21.4%	24.0%	30.2%	6.5%	12.1%
DK	44.0%	51.7%	83.9%	84.3%	44.5%	51.4%	46.8%	54.9%
EE	3.2%	-	95.8%	-	5.7%	-	3.4%	-
ES	5.9%	6.1%	15.3%	15.1%	17.7%	18.4%	10.3%	10.7%
FI	19.6%	21.2%	59.9%	75.2%	29.7%	29.2%	26.6%	28.6%
FR	3.7%	3.7%	10.5%	10.4%	27.7%	27.3%	5.2%	5.2%
EL	0.7%	-	0.0%	-	6.9%	-	0.8%	-
HR	0.0%	-	0.0%	-	4.2%	-	0.0%	-
HU	2.1%	-	22.2%	-	8.4%	-	2.0%	-
IE	1.7%	4.7%	0.9%	15.1%	19.4%	4.5%	3.6%	9.6%
IS	14.1%	15.1%	93.7%	94.3%	20.8%	21.5%	20.7%	22.1%

	CB liabilities/total assets		CB (% total liabilities that are source of encumbrance)		Asset encumbrance ratio		CB/total assets	
IT	4.7%	6.0%	23.8%	27.4%	20.2%	21.5%	9.6%	12.1%
LI	0.0%	-	0.0%	-	4.7%	-	0.6%	-
LT	0.0%	-	0.0%	-	0.2%	-	0.0%	-
LU	0.0%	-	0.0%	-	3.0%	-	0.0%	-
LV	0.0%	-	0.0%	-	4.9%	-	0.0%	-
MT	0.0%	-	0.0%	-	5.0%	-	0.0%	-
NL	w5.8%	6.7%	30.8%	34.3%	15.4%	15.9%	9.9%	11.3%
NO	22.4%	29.6%	77.0%	84.6%	23.7%	24.8%	15.2%	19.8%
PL	0.7%	1.1%	31.9%	44.0%	2.3%	3.0%	1.3%	2.2%
PT	4.4%	-	11.3%	-	3.4%	-	6.4%	-
RO	0.0%	-	0.0%	-	1.0%	-	0.0%	-
SE	12.9%	15.7%	74.2%	74.8%	20.5%	23.8%	22.3%	27.1%
SI	0.0%	-	0.0%	-	3.7%	-	0.0%	-
SK	0.0%	-	98.5%	-	16.5%	-	0.0%	-
EU avg.	6.3%	8.1%	22.8%	26.8%	22.6%	24.7%	9.2%	11.8%

Source: FINREP and EBA calculations. For the sample of covered bond issuers, some countries are excluded because they have less than three banks in their sample (EE, EL, HU, PT, SK).

Figure 34: Descriptive statistics for the total sample, December 2024, consolidated reporting data

	Covered bond liabilities / Total assets	Covered bonds (% Total liabilities source of encumbrance)	Asset Encumbrance ratio	Cover assets / Total assets
Weighted avg.	6%	23%	23%	9%
Median	0%	0%	5%	0%
Min	0%	0%	0%	0%
Max	95%	100%	100%	95%
St Dev	6%	18%	12%	7%
P (25)	0%	0%	0%	0%
P (75)	0%	0%	12%	0%
P (95)	3%	39%	32%	6%

Source: FINREP and EBA calculations.

Figure 35: Descriptive statistics for the sample of covered bond issuers, December 2024, consolidated reporting data

	Covered bond liabilities / Total assets	Covered bonds (% Total liabilities source of encumbrance)	Asset Encumbrance ratio	Cover assets / Total assets
Weighted avg.	8%	27%	25%	12%
Median	8%	49%	23%	12%
Min	0%	0%	0%	0%
Max	90%	100%	93%	95%
St Dev	18%	33%	18%	20%
P (25)	3%	24%	15%	6%
P (75)	14%	81%	33%	23%
P (95)	49%	100%	66%	57%

Source: FINREP and EBA calculations.

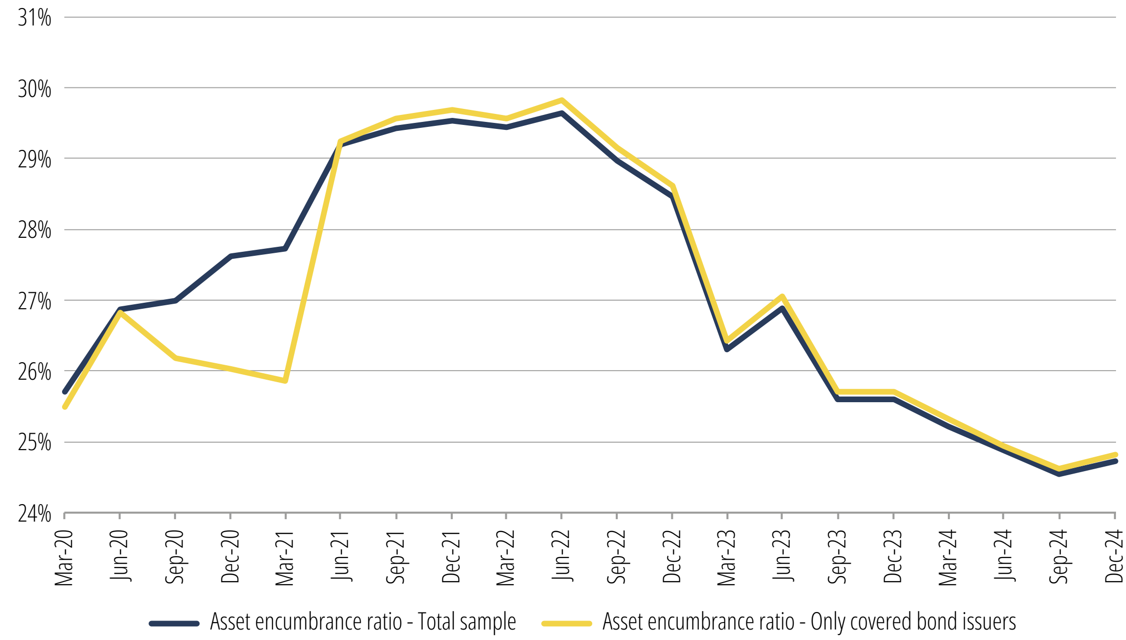
Figure 36: Covered bond liabilities as a share of total assets and as a share of total liabilities that are source of encumbrance, December 2024, individual reporting data

Country	Covered bond liabilities / Total assets		Covered bonds (% Total liabilities that are source of encumbrance)		Asset Encumbrance ratio		Cover assets / Total assets	
	Total sample	Covered bond issuers	Total sample	Covered bond issuers	Total sample	Covered bond issuers	Total sample	Covered bond issuers
AT	10.2%	15.5%	58.2%	60.2%	27.7%	29.2%	19.1%	29%
BE	3.7%	5.3%	22.5%	23.7%	10.9%	14.9%	6.2%	9%
BG	0.0%	-	0.0%	-	3.1%	-	0.0%	-
CY	0.0%	-	0.0%	-	6.1%	-	1.6%	-
CZ	1.1%	1.9%	28.0%	12.4%	13.6%	14.6%	5.8%	10%
DE	3.5%	9.4%	14.0%	37.9%	20.3%	29.6%	5.8%	16%
DK	51.1%	63.7%	86.5%	87.7%	53.0%	65.0%	53.2%	66%
EE	2.1%	-	95.0%	-	3.8%	-	2.3%	-
ES	7.2%	8.0%	14.1%	12.8%	17.4%	19.2%	13.1%	15%
FI	5.9%	44.9%	25.2%	98.3%	23.1%	48.7%	8.0%	60%
FR	18.8%	43.3%	22.8%	95.8%	39.7%	25.0%	29.9%	72%
GR	0.8%	-	0.0%	-	8.6%	-	0.9%	-
HR	0.0%	-	0.0%	-	1.6%	-	0.0%	-

Country	Covered bond liabilities / Total assets		Covered bonds (% Total liabilities that are source of encumbrance)		Asset Encumbrance ratio		Cover assets / Total assets	
	Total sample	Covered bond issuers	Total sample	Covered bond issuers	Total sample	Covered bond issuers	Total sample	Covered bond issuers
HU	2.6%	48.7%	25.1%	100.0%	13.3%	80.2%	3.0%	61%
IE	1.7%	33.2%	8.5%	100.0%	20.6%	39.4%	3.5%	68%
IS	14.2%	15.1%	90.2%	90.8%	20.6%	21.7%	20.8%	22%
IT	4.2%	6.3%	18.9%	25.2%	18.5%	19.4%	7.8%	11%
LI	0.0%	-	0.0%	-	2.1%	-	0.0%	-
LT	0.0%	-	0.0%	-	0.2%	-	0.0%	-
LU	0.7%	-	5.0%	-	6.0%	-	0.9%	-
LV	0.0%	-	0.0%	-	1.0%	-	0.0%	-
MT	0.0%	-	0.0%	-	1.2%	-	0.0%	-
NL	6.9%	7.8%	33.0%	36.6%	14.5%	14.9%	10.9%	12%
NO	16.0%	63.9%	86.0%	99.5%	23.0%	71.4%	18.9%	76%
PL	0.4%	38.9%	22.1%	99.6%	2.3%	81.8%	0.9%	81%
PT	8.8%	12.8%	35.7%	44.7%	6.4%	6.5%	11.5%	15%
RO	0.0%	-	0.0%	-	0.8%	-	0.0%	-
SE	12.2%	22.6%	78.0%	88.6%	20.1%	34.8%	20.6%	38%
SI	0.0%	-	0.0%	-	1.1%	-	0.0%	-
SK	0.0%	0.0%	89.3%	93.7%	15.0%	17.5%	0.0%	0%
EU avg.	**7.8%**	**14.7%**	**36.3%**	**54.1%**	**19.4%**	**25.7%**	**11.4%**	**21%**

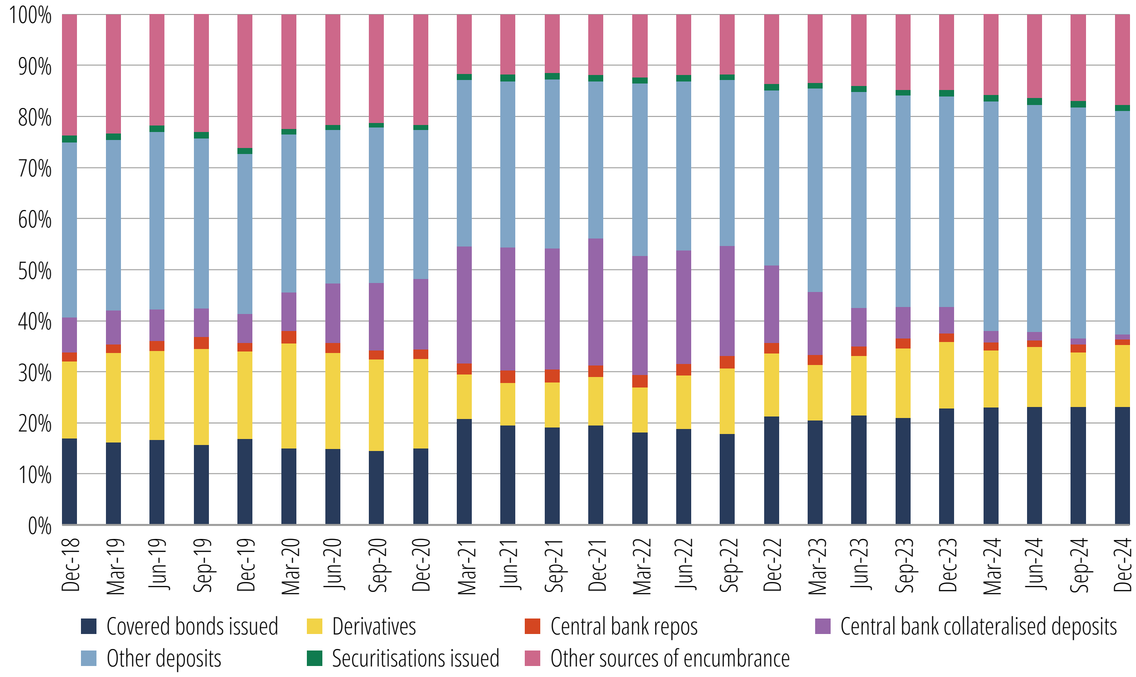
Source: FINREP and EBA calculations. For the sample of covered bond issuers, some countries are excluded because they have less than three banks in their sample (EE, EL, LU, RO).

Figure 37: Evolution of asset encumbrance ratio, Q1 2020 to Q4 2024, percentage of total assets



Source: FINREP and EBA calculations.

Figure 38: Evolution of the sources of encumbrance, Q4 2018 to Q4 2024, percentage of total encumbered assets



Source: FINREP and EBA calculations.

15.4 EU banks' cover pools composition

Data on the asset classes of cover pools in accordance with Article 129(1) of the CRR have been obtained from FINREP. ([410]) The template of the asset class of cover pools has been merged with the template of the carrying amount of each cover pool, which is also obtained from FINREP. ([411]) The merge has been done by issuer bank and by identifier of the cover pool.

The asset classes of cover pools are reported by banks in the template F 35.00.c for covered bonds that are compliant with Article 129 of the CRR. The reporting is done by specifying the items in the list of Article 129(1) of the CRR (Figure 39) that correspond to the primary asset class. ([412]) In some instances, banks did not report the primary asset class of Article 129 of the CRR-compliant covered bonds issued from their groups. The situation has improved compared to the data as of September 2024, as only 3% of the nominal amount of covered bonds does not have the primary asset class reported in F 35.00.c. The banks that did not report the asset class of the cover pool are from Austria, Germany, France, Italy, and Sweden. In some cases, this may be the result of a reporting error, or because the primary asset class is non-compliant with the CRR (e.g. in Germany).

RRE assets are mainly reported in the asset class under Article 129(1) (d) of the CRR, while only banks from France report them in the category under Article 129(1)(e) of the CRR. The situation has improved compared to data as of December 2023, when banks from four other countries were reporting amounts in this asset class. The reporting of RRE under Article 129(1)(e) of the CRR in France comes as no surprise, as a significant part of the loans to natural persons for the purchase of residential properties in that country are guaranteed by an eligible protection provider qualifying for the credit quality step 2 or above, as referred to in Article 201 of the CRR.

Figure 39: Cover pool asset classes reported in FINREP as of December 2024

Primary asset class reported in F 35.00.c	Asset class defined in Article 129(1)(a) of the CRR	Short label asset class
a–Primary asset class specified in Article 129(1)(a)	Exposures to or guaranteed by central governments, ESCB central banks, public sector entities, regional governments, or local authorities in the Union.	EU public sector
b–Primary asset class specified in Article 129(1)(b)	Exposures to or guaranteed by third country central governments, third-country central banks, multilateral development banks, international organisations that qualify for the CQS 1 as set out in this Chapter, and exposures to or guaranteed by third-country public sector entities, third country regional governments or third-country local authorities that are risk weighted as exposures to institutions or central governments and central banks in accordance with Article 115(1) or 115(2) of the CRR, or Article 116(1), 116(2) or 116(4) of the CRR respectively and that qualify for the credit quality step 1 as set out in this Chapter, and exposures within the meaning of this point that qualify as a minimum for the CQS 2 as set out in this Chapter, provided that they do not exceed 20% of the nominal amount of outstanding covered bonds of the issuing institutions.	Third country public sector
c–Primary asset class specified in Article 129(1)(c)	Exposures to institutions that qualify for the CQS 1 as set out in this Chapter. The total exposure of this kind shall not exceed 15% of the nominal amount of outstanding covered bonds of the issuing institution. Exposures to institutions in the Union with a maturity not exceeding 100 days shall not be comprised by the step 1 requirement but those institutions shall as a minimum qualify for CQS 2 as set out in this Chapter.	Institutions

([410]) Asset class of cover pools: row 10, column 12 of F 35.00.c (FINREP reporting).

([411]) Carrying amount of cover pools: row 40, column 150 of F 35.00.a (FINREP reporting).

([412]) Primary is understood to mean the asset class having the largest share in the cover pool.

Primary asset class reported in F 35.00.c	Asset class defined in Article 129(1)(a) of the CRR	Short label asset class
d–Primary asset class specified in Article 129(1)(d)	Loans secured by: (i) residential property up to the lesser of the principal amount of the liens that are combined with any prior liens and 80% of the value of the pledged properties, or (ii) senior units issued by French Fonds Communs de Titrisation or equivalent securitisation entities governed by the laws of a Member State securitising residential property exposures.	RRE 1
e–Primary asset class specified in Article 129(1)(e)	Residential loans fully guaranteed by an eligible protection provider referred to in Article 201 of the CRR qualifying for the CQS2 or above as set out in this Chapter, where the portion of each of the loans that is used to meet the requirement set out in this paragraph for collateralisation of the covered bond does not represent more than 80% of the value of the corresponding residential property located in France, and where a loan-to-income ratio respects at most 33% when the loan has been granted.	RRE 2
f–Primary asset class specified in Article 129(1)(f)	Loans secured by: (i) commercial immovable property up to the lesser of the principal amount of the liens that are combined with any prior liens and 60% of the value of the pledged properties, or (ii) senior units issued by French Fonds Communs de Titrisation or equivalent securitisation entities governed by the laws of a Member State securitising commercial immovable property exposures.	CRE
g–Primary asset class specified in Article 129(1)(g)	Loans secured by maritime liens on ships up to the difference between 60% of the value of the pledged ship and the value of any prior maritime liens.	Ship
h–Primary asset class not specified in Article 129(1)	-	

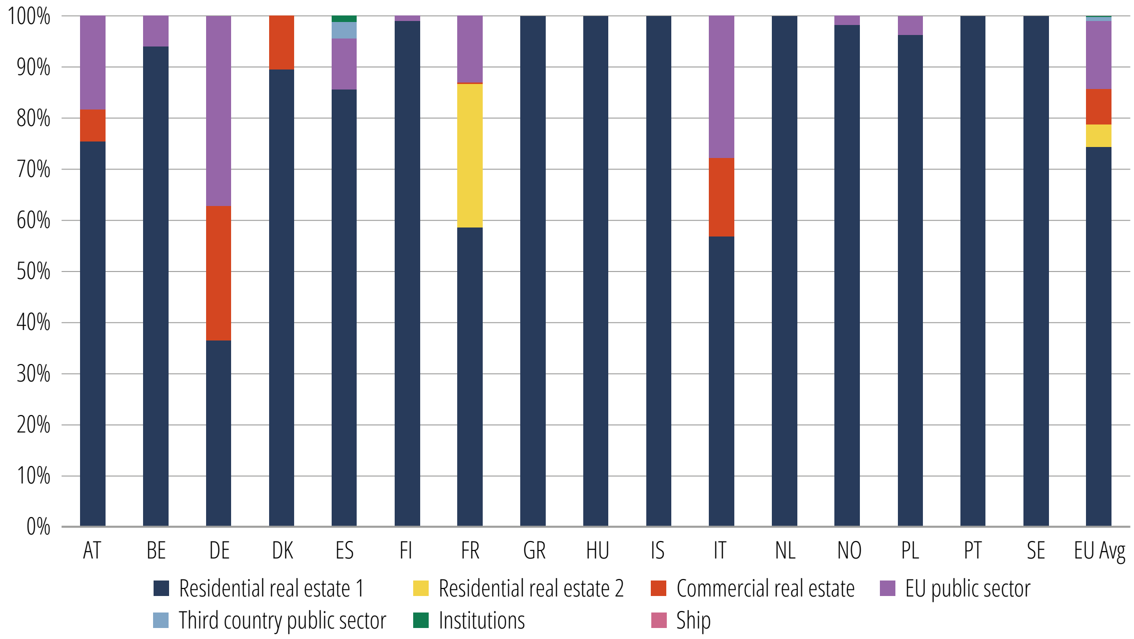
Source: FINREP and EBA calculations.

Figure 40 shows the distribution of cover pool assets by asset class under Article 129(1) of the CRR. As of December 2024, cover pools are mainly composed by RRE assets (77%), followed by EU public sector assets (13%), CRE assets (7%) and third country public sector assets (1%).

The share of CRE is high in Czechia (49% of the cover pool assets), followed by Germany and Italy (23% and 15% of cover pool assets, respectively). Other jurisdictions have a share of CRE assets of 10% (Denmark) and 6% (Austria). Banks from the other jurisdictions do not report CRE assets as part of their cover pools.

Lastly, EU public sector assets represent 33% of the cover pool assets in Germany, 28% in Italy, 17% in Austria, 13% in France and 10% in Spain. In the rest of the jurisdictions, EU public sector assets represent less than 5% of the cover pool assets.

Figure 40: Composition of cover pool assets across jurisdictions by type of product, December 2024, percentage of total cover pool assets



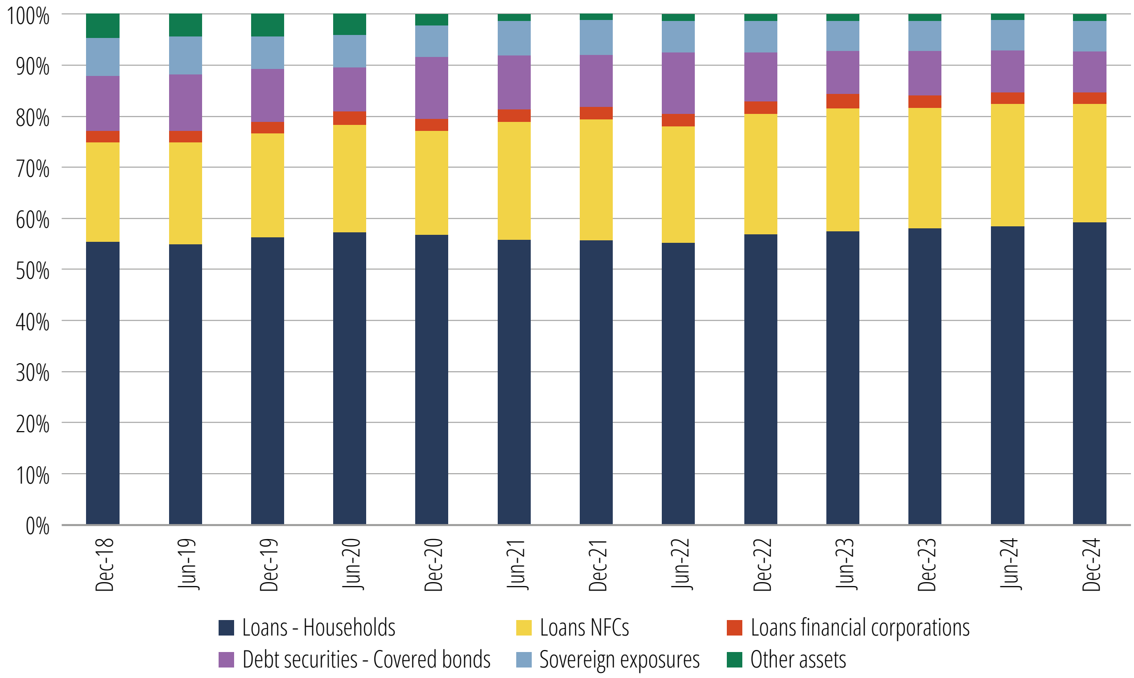
Source: FINREP and EBA calculations, based on consolidated reporting. Banks from CY, CZ, EE, HU, IE, LI, LU, RO and SK are not included because there are less than three banks reporting the template F 35.00.c with the highest level of consolidation EEA. The figure includes the distribution of cover pool assets by asset class eligible under CRR and reported in asset encumbrance reporting, which are 89% of the cover pool assets. Those that are not eligible do not have the asset class informed in the supervisory reporting and are not included in this chart but only represent 11% of cover pool assets.

The EBA has also analysed FINREP data on the product types that are part of cover pools over time (Figure 41) and by counterparty (Figure 42). ([413]) As of December 2024, cover pools are mainly composed by loans to households (59%), loans to non-financial corporations (23%), loans to financial corporations (2%), covered bonds (8%), sovereign exposures (6%) and other assets (1%).

The countries with an above average presence of loans to non-financial corporations in their cover pools are France (38%), Germany (36%), Denmark (33%), Austria (26%) and Italy (14%). Most of these loans to NFCs are collateralised with immovable property (100% in Denmark, 91% in Germany, 85% in Austria, and 77% in Italy) and most likely correspond to the asset class of CRE loans as these are the countries with high shares of CRE loans in their cover pools in the reporting of covered bond issuance (Figure 43).

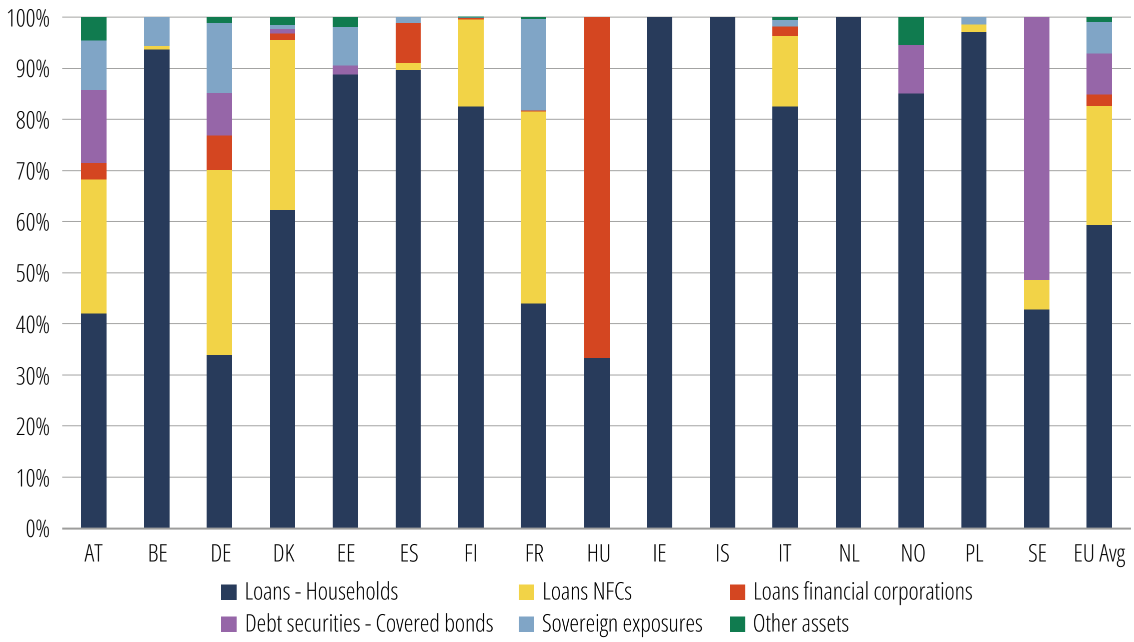
([413]) Product type of cover pools: row 120, all rows of F 36.01.b (FINREP reporting).

Figure 41: Composition of cover pools over time, December 2018 to December 2024, percentage of total cover pool assets



Source: FINREP and EBA calculations, based on consolidated reporting.

Figure 42: Composition of cover pool assets across jurisdictions by counterparty of the institution, December 2024, percentage of total cover pool assets



Source: FINREP and EBA calculations, based on consolidated reporting.

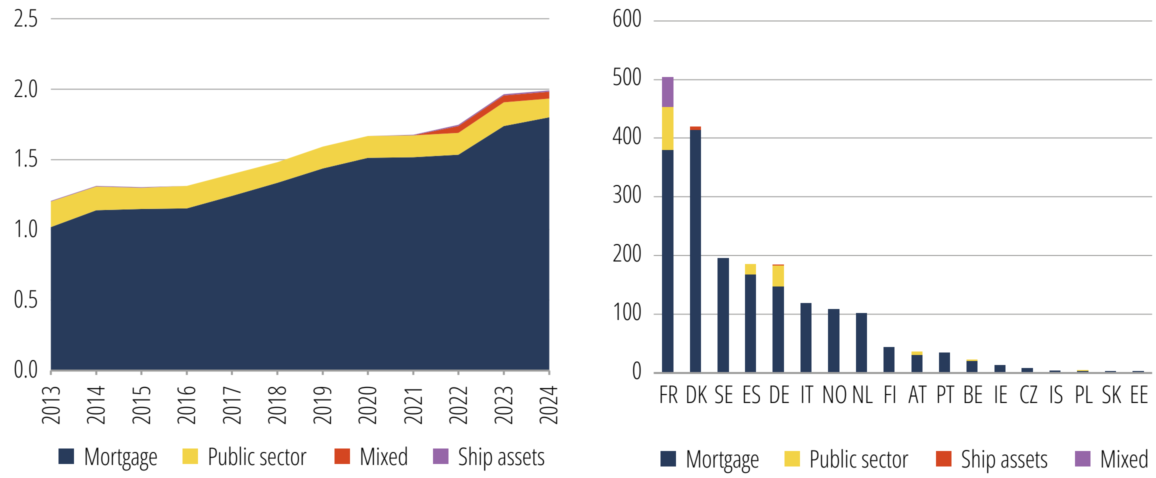
15.5 Outstanding amount of covered bonds

According to the ECBC, the outstanding amount of the EU covered bond market is EUR 2.5 trillion as of December 2023. The figure includes the outstanding amount of covered bonds issued by entities domiciled in the EU. As of December 2023, the main markets are France (EUR 468 billion), Denmark (EUR 465 billion), and Germany (EUR 400 billion). These three countries represent together more than half of the covered bond market in the EU.

According to FINREP data on the nominal amount of covered bond funding of EU banking groups, as of December 2024 the outstanding amount of covered bond funding was EUR 2.3 trillion (Figure 44). [414] This data includes the covered bonds issued by all entities that belong to EU banking groups. These entities consist of the parent entity domiciled in the EU, the subsidiaries domiciled in the EU and those domiciled in third countries.

Considering only individual data (i.e. which excludes the outstanding amount of covered bonds issued by subsidiaries of EU banks located in third countries), the outstanding amount of covered bond funding is EUR 1.98 trillion, comparable with ECBC data.

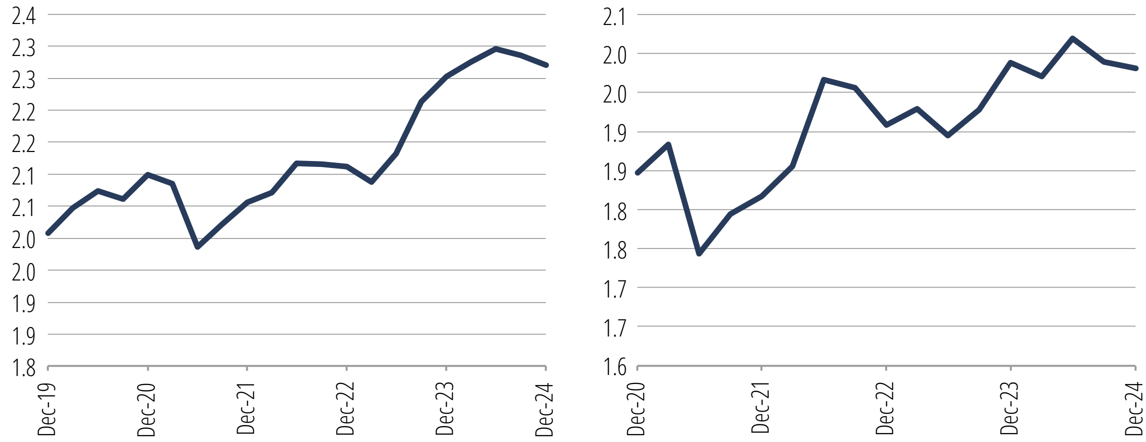
Figure 43: Outstanding amounts of the EU covered bond market on an individual basis by year (trillion euro; left) and by country (billion euro; right), December 2024



Source: ECBC and EBA calculations.

[414] Nominal amount of covered bonds: row 10, column 20 of F 35.00.a (FINREP reporting).

Figure 44: Outstanding nominal amount of the EU covered bond market on a consolidated basis (left) and on an individual basis (right), Q4 2019 (left) and Q4 2020 (right) to Q4 2024, trillion euro

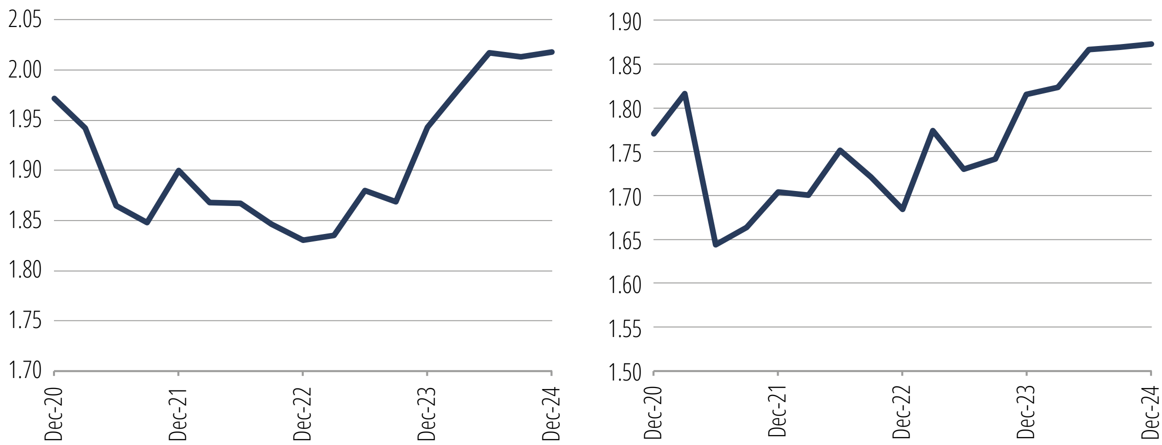


Source: FINREP and EBA calculations based on consolidated data.

According to FINREP data on the carrying amount of covered bond funding of EU banking groups, as of December 2024, the outstanding amount was EUR 2 trillion ([415]) (Figure 45). This data includes the covered bonds issued by all entities that belong to EU banking groups. These entities consist of the parent entity domiciled in the EU, the subsidiaries domiciled in the EU, and those domiciled in third countries.

Considering only individual data (i.e. excluding the outstanding amount of covered bonds issued by subsidiaries of EU banks located in third countries), the outstanding amount of covered bond funding is EUR 1.9 trillion, which is comparable with ECBC data.

Figure 45: Outstanding carrying amount of the EU covered bond market based on a consolidated basis (left) and on an individual basis (right), Q4 2020 to Q4 2024, trillion euro



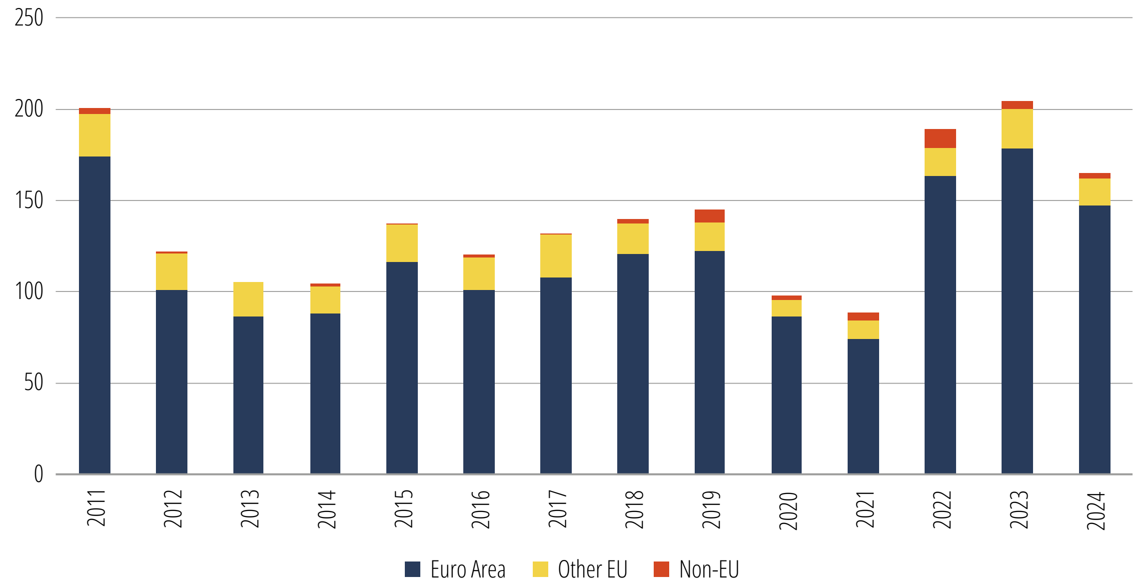
Source: FINREP and EBA calculations based on consolidated data.

([415]) Nominal amount of covered bonds: row 10, column 20 of F 35.00.a (FINREP reporting).

15.6 Issuance volume of covered bonds issuance volume

The issuance activity of covered bonds during 2024 declined compared to the level observed in 2023 but remains above the level observed during the last ten years. Issuance volumes declined during crisis periods (e.g. sovereign debt crisis of 2012-2013, COVID-19 of 2020) but resumed under the net purchases of covered bonds conducted by the ECB between October 2014 and December 2018 (Figure 46).

Figure 46: Covered bond issuance volumes of EU banks, 2011 to 2024, billion euro

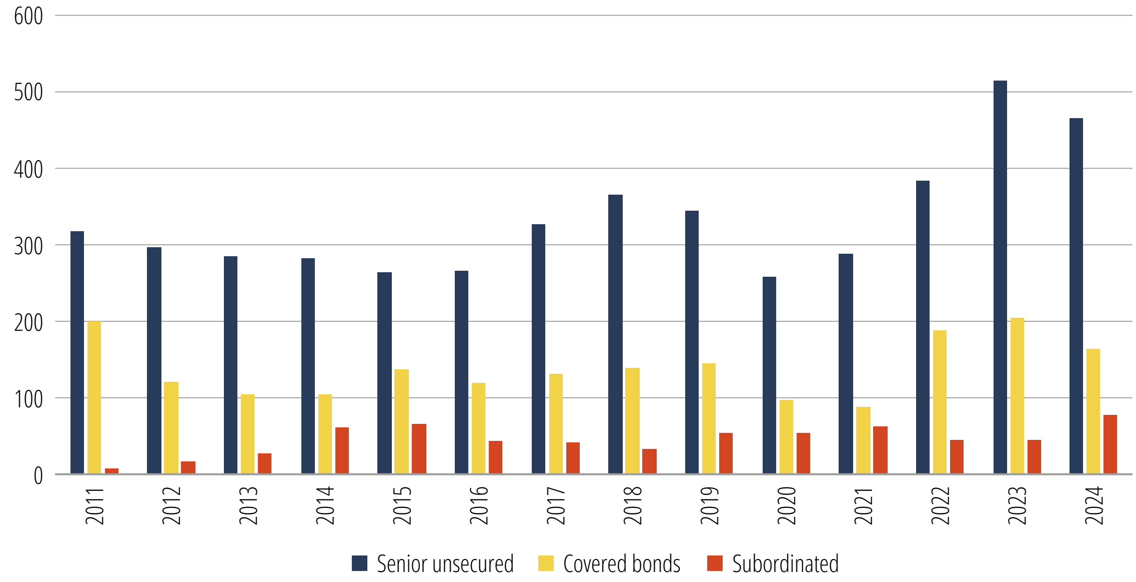


Source: Dealogic and EBA calculations.

The issuance volumes of covered bonds are well below the issuances observed for senior unsecured bonds (Figure 47). The gap between the two widened further during 2017 and 2018 because of the anticipation effect on markets of the new resolution framework articulated through the BRRD II before it came into force in 2019. This anticipation effect of the new resolution framework has been confirmed by recent literature. ([416])

([416]) Monjas, Rocamora and Suarez (2023), 'Determinants of bail-in in the EU banking sector'. *Journal of European Economics – Empirica*, Volume 50, 2023, pp. 1055–1095.

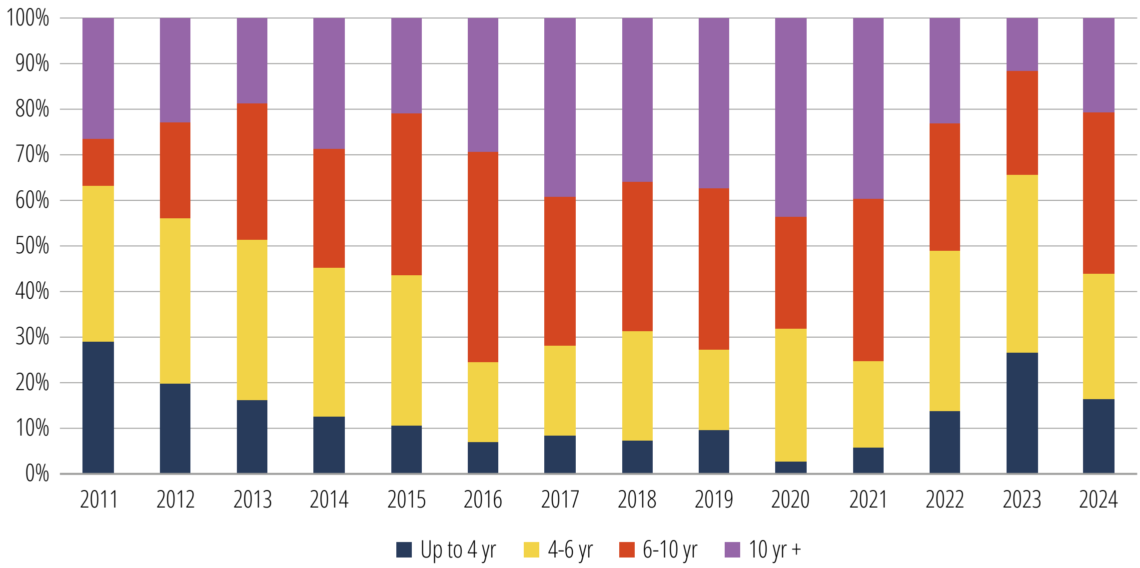
Figure 47: Issuance volumes of senior unsecured debt, subordinated debt and covered bonds, 2011 to 2024, billion euro



Source: Dealogic and EBA calculations.

The policy rate hike cycle boosted issuance, as covered bonds are the cheapest source of wholesale funding. However, banks were issuing at shorter maturities under the period of monetary policy tightening of 2022 and 2023, given the lower yields associated with the maturity segment (Figure 48). Since June 2024, interest rate cuts made by the ECB impacted the maturity structure, with EU banks issuing covered bonds with longer original maturities. Thus, maturities between 6 and 10 years and maturities above ten years were more frequent in 2024 compared to those done during 2022 and 2023.

Figure 48: Composition of issuance volumes by maturity profile, 2011 to 2024, percentage



Source: Dealogic and EBA calculations.

15.7 Over-collateralisation

Over-collateralisation is defined as the nominal amount of the cover pool ([417]) divided by the nominal amount of covered bond liabilities. ([418])

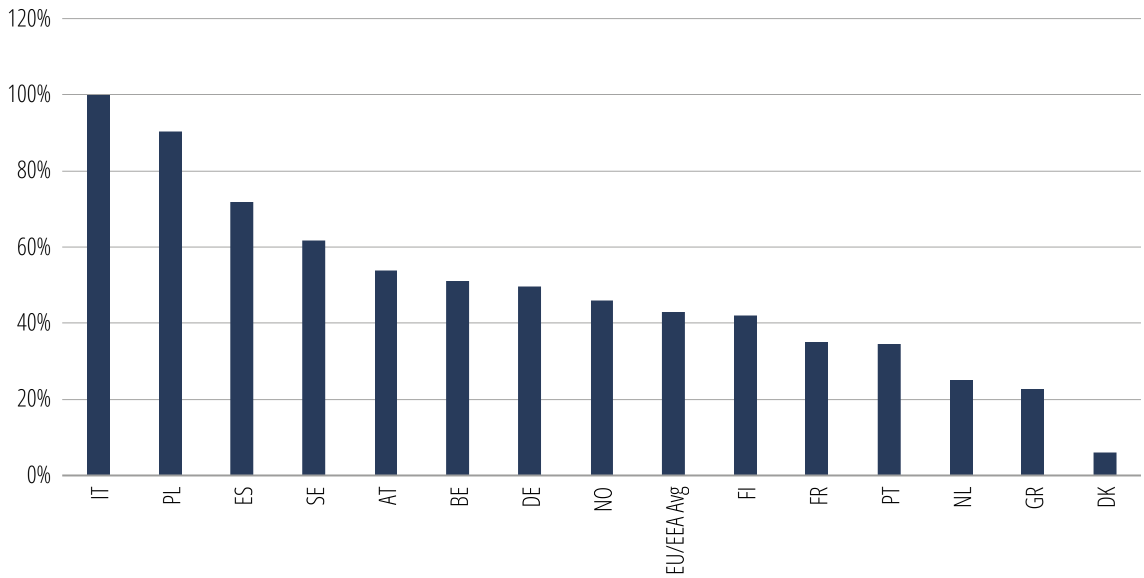
The formula is also used by recent literature on the topic (Grothe and Zeyer (2020)). ([419])

The formula for the over-collateralisation used for the calculation is:

$$\mathit{Overcollateralisation} = 100 * \left(\frac{\mathit{Nominal\ amount\ of\ cover\ pool}}{\mathit{Nominal\ amount\ of\ covered\ bond\ liabilities}} - 1\right)$$

As of December 2024, EU/EEA banks report an over-collateralisation ratio at 43% ranging from 6% (Denmark) to 111% (Ireland). ([420]) As one can see in Figure 49 and Figure 50, there is high heterogeneity, both across and within jurisdictions. ([421])

Figure 49: Over-collateralisation by country, December 2024, percentage



Source: FINREP and EBA calculations. Only countries with at least three banks in their sample are included in the chart. Data based on consolidated reporting.

([417]) Nominal amount of cover pools: row 10, column 150 of F 35.00.a (FINREP reporting).

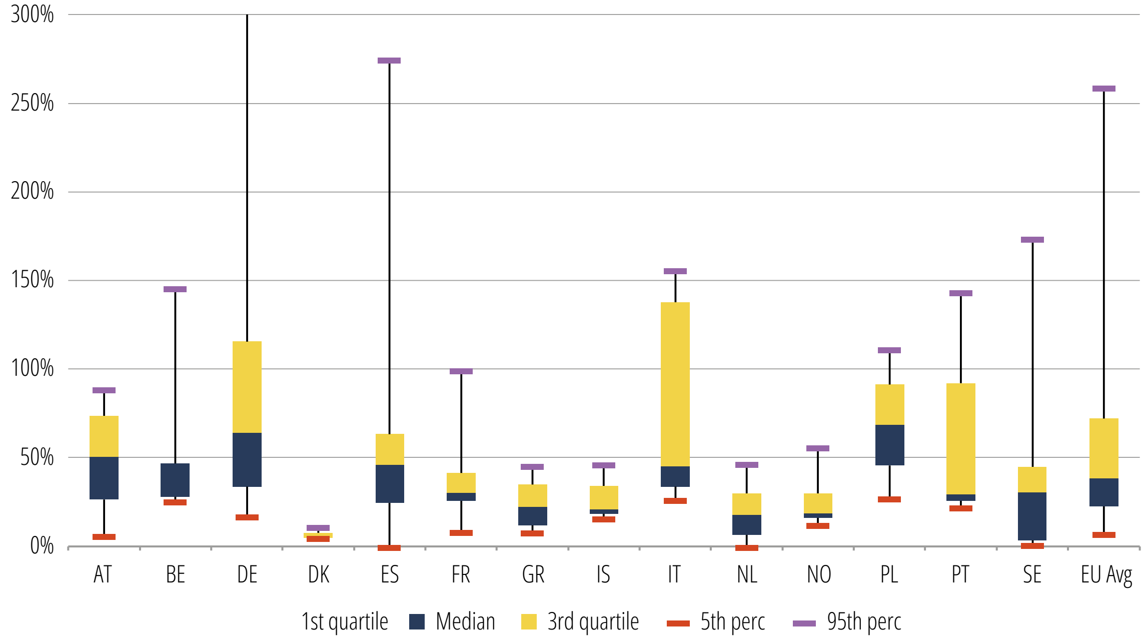
([418]) Nominal amount of covered bond liabilities: row 10, column 20 of F 35.00.a (FINREP reporting).

([419]) See Grothe and Zeyer (2020), Risk characteristics of covered bonds: monitoring beyond ratings, ECB WP No 2393/2020.

([420]) F 35.00.a (FINREP reporting).

([421]) It must be stressed that part of this high variation may be due to a partial misreporting caused by possibly unclear reporting instructions, especially on delineating the inclusion of encumbered versus unencumbered assets, or on specifying whether cover pool derivative hedge positions should be included or not.

Figure 50: Distribution of over-collateralisation levels by country, December 2024, percentage



Source: FINREP and EBA calculations. Only countries with at least three banks in their sample are included in the chart. The 95th percentile of DE is 553% due to four small banks reporting high over-collateralisation ratios, but the figure has been limited at 300% for visibility purposes. Data based on consolidated reporting.

Figure 51: Distribution of over-collateralisation levels, EU average only, December 2024, percentage

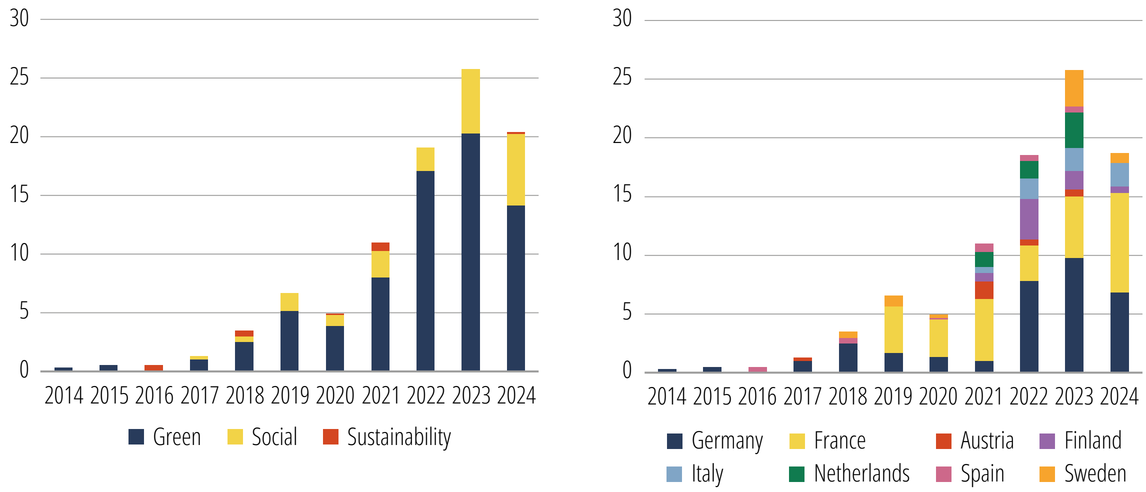
	Weighted average	5th perc	1st quartile	Median	3rd quartile	95th perc
EU avg.	42.8%	9.2%	24.3%	43.0%	74.6%	268.9%

Source: FINREP and EBA calculations.

15.8 Green covered bonds

Market supply of sustainable covered bonds shows a rapid growth over the recent years and represents at present more than 10% of total issuances. Issuances are dominated by Germany with 34% of the total issuances in 2024 (Figure 52).

Figure 52: Issuance volumes of green covered bonds by type (left) and by country (right), 2014 to2024, billion euro

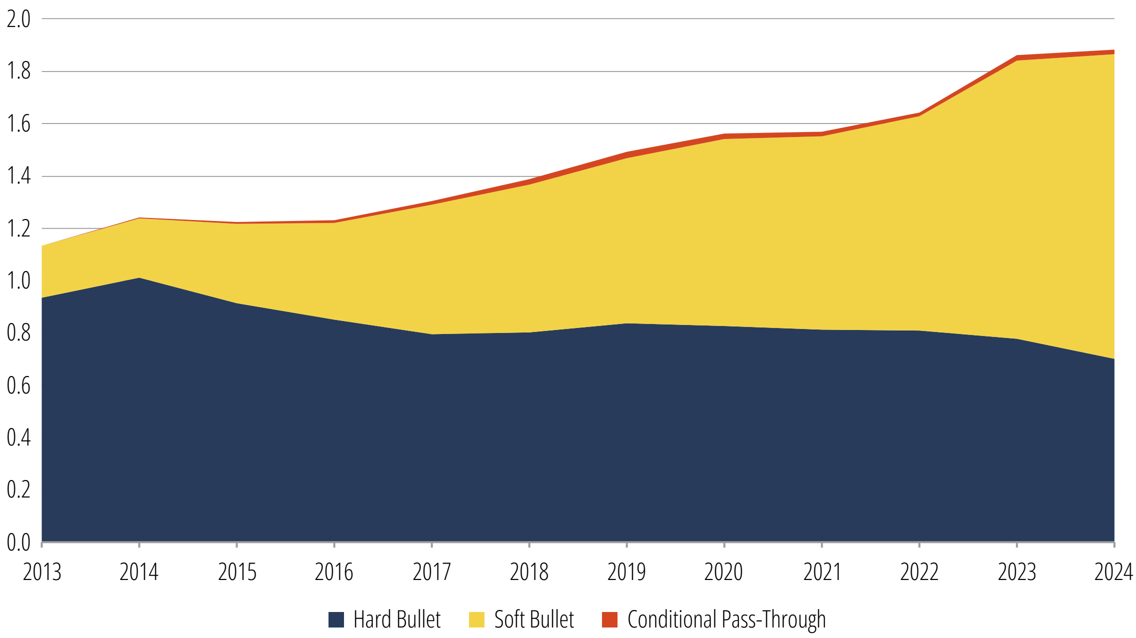


Source: Dealogic and EBA calculations.

15.9 Covered bonds with extendable maturity structures

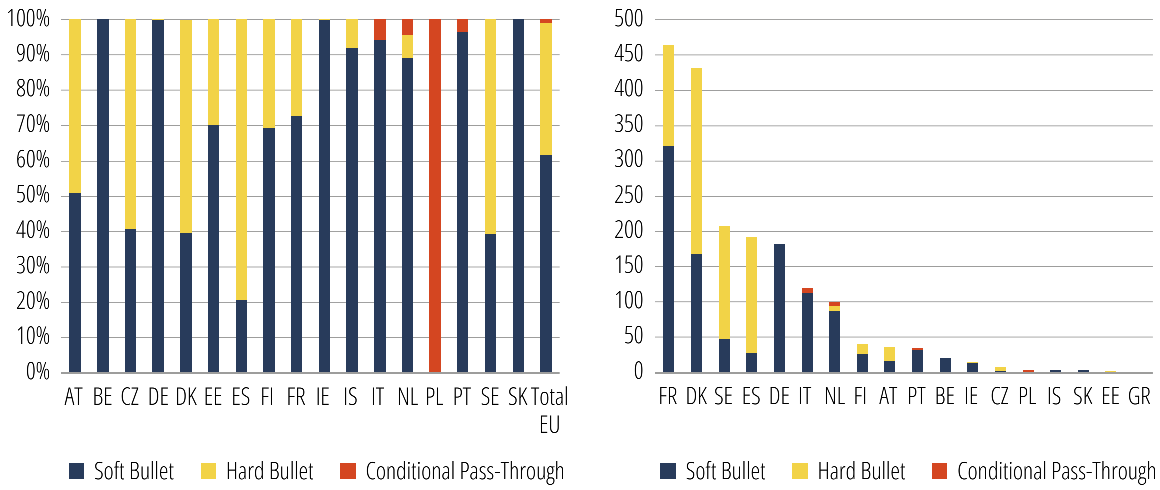
The outstanding amount of covered bonds with extendable maturity structures represents 69% of the total as of December 2024. Data on the outstanding volume of covered bonds with extendable maturities have been obtained from ECBC.

Figure 53: Outstanding amounts in the covered bond market by bullet structure, 2013 to 2024, trillion euro



Source: ECBC and EBA calculations.

Figure 54: Outstanding amounts of the covered bond market by composition of maturity profile and by country, December 2024, percentage (left) and billion euro (right)



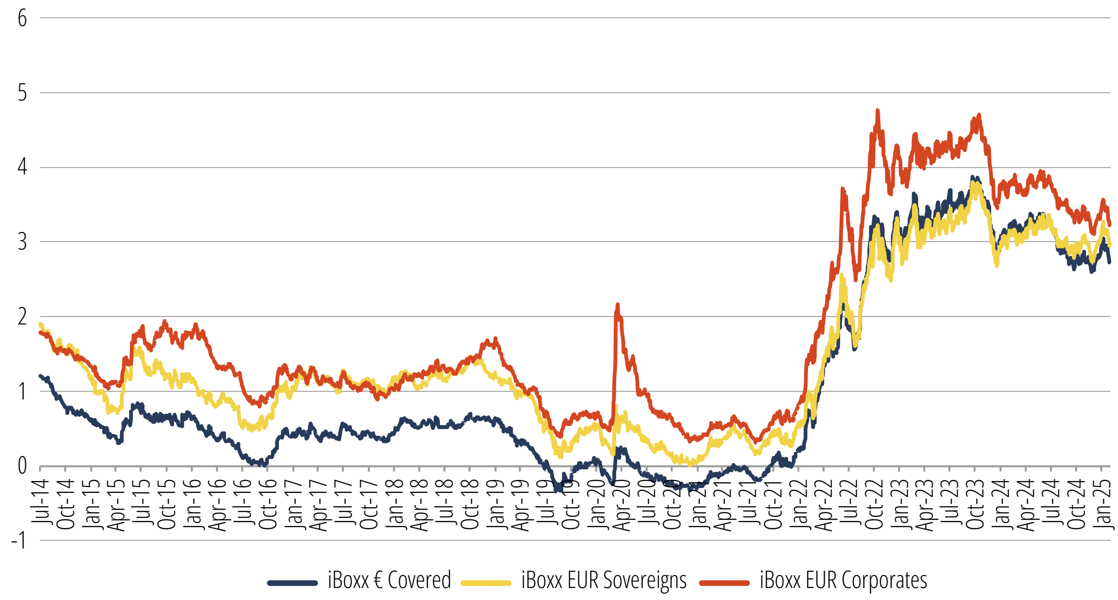
Source: ECBC and EBA calculations.

15.10 Developments in realised yields for covered bond holders

This section shows the main market indicators of covered bonds. Figure 55 shows the comparison between the yields of covered bonds, corporate bonds, and sovereign bonds. Figure 56 shows the comparison between covered bonds and unsecured bonds, such as senior unsecured bonds, senior non-preferred bonds, Tier 2 and AT1 instruments. This section also shows the credit spreads by country (Figure 57) and the comparison of the spreads of covered bonds and securitisations of the same credit quality (Figure 58). Lastly, to know the evolution of the credit quality of covered bonds included in the index, the EBA will show the evolution of the nominal amount of the EUR covered bond index by credit quality.

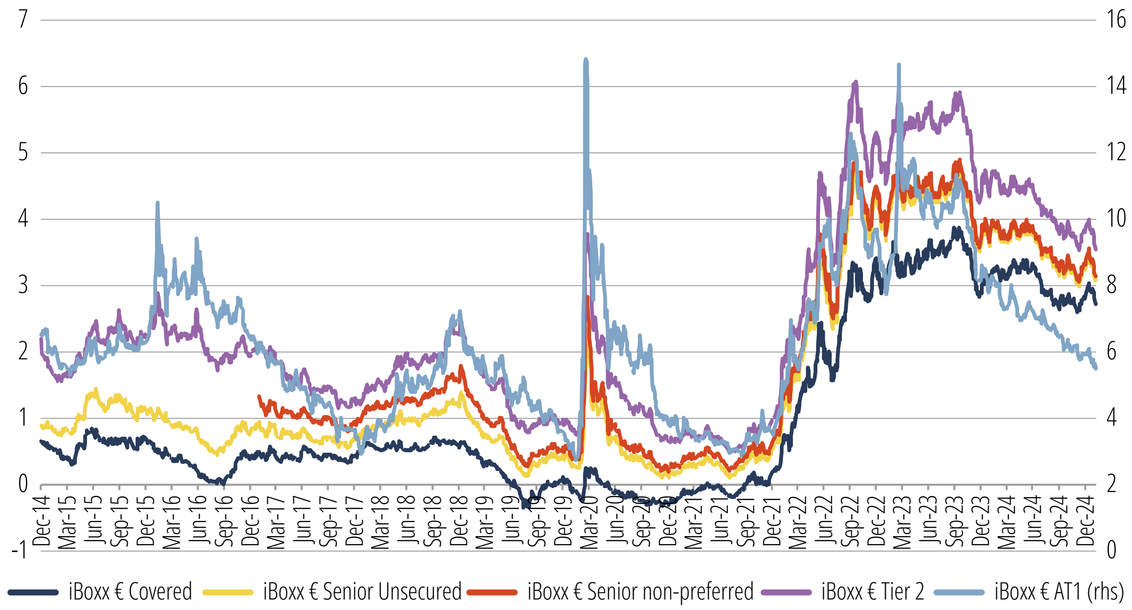
The spread between the yields of covered bonds and sovereign bonds tightened in recent years (Figure 55), in line with the improvement of the credit quality of covered bonds and the decision taken by the ECB to discontinue the APP. As can be observed in Figure 59, the nominal amount of covered bonds rated AAA has increased significantly since Q1 2021.

Figure 55: Yield to maturity of iBoxx € Covered, iBoxx € Sovereigns and iBoxx € Corporates, July 2014 to December 2024, percentage



Source: Markit and EBA calculations.

Figure 56: Yield to maturity of iBoxx € Covered, iBoxx € Senior Unsecured, iBoxx € Senior non-preferred and iBoxx € Tier 2 (left axis), and iBoxx € AT1 (right axis), December 2014 to December 2024, percentage

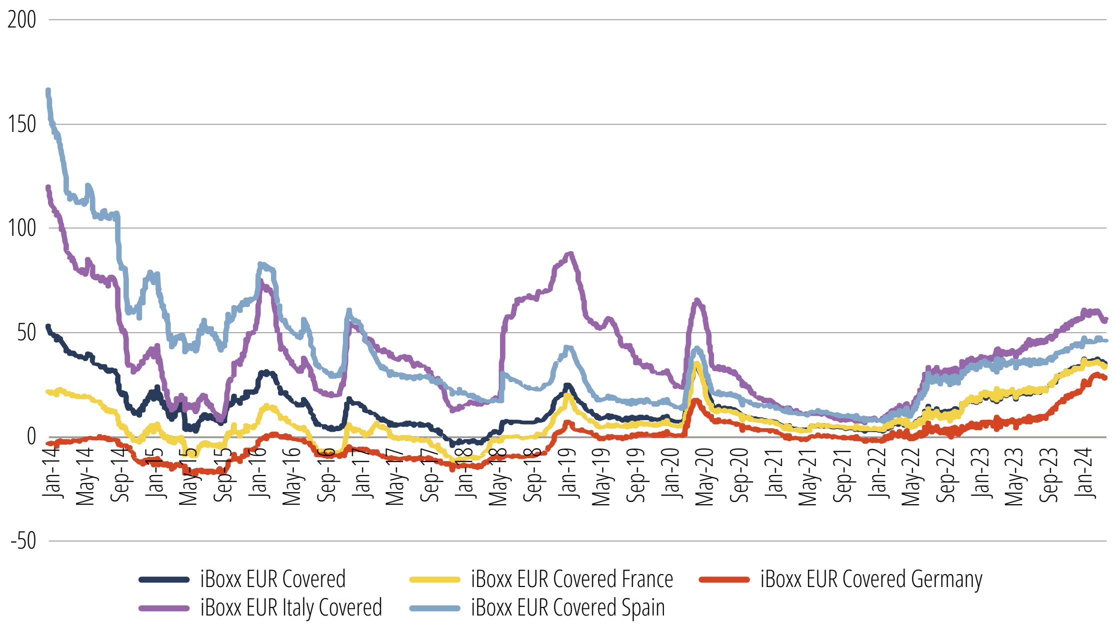


Source: Markit and EBA calculations.

High heterogeneity is observed in the spreads of the different covered bond markets in the EU (Figure 57). While French and German banks are showing spreads below the average of the index, Spanish and Italian banks are well above the average of the index.

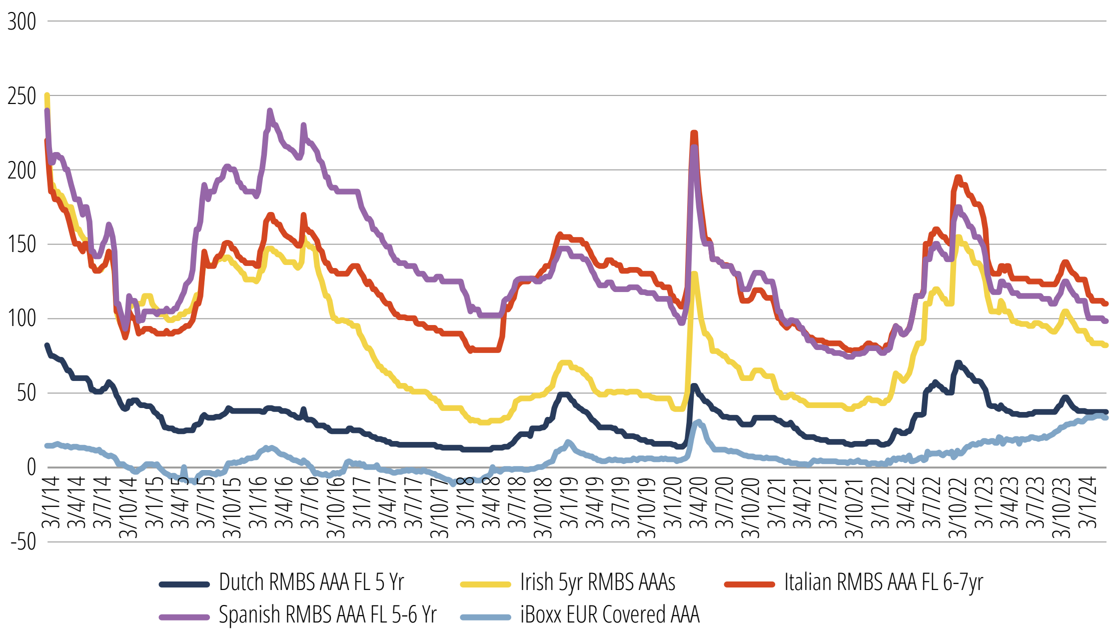
In a similar vein, while mortgage-backed securities have sharply reduced the spreads after the 2008 crisis, they remain above the spreads of covered bonds, even considering the spreads of the tranches with the highest credit quality (AAA). Thus, mortgage-backed securities are still perceived as riskier by investors.

Figure 57: Credit spreads between iBoxx EUR Covered Indexes and sovereign rates by country, January 2014 to December 2014, basis points



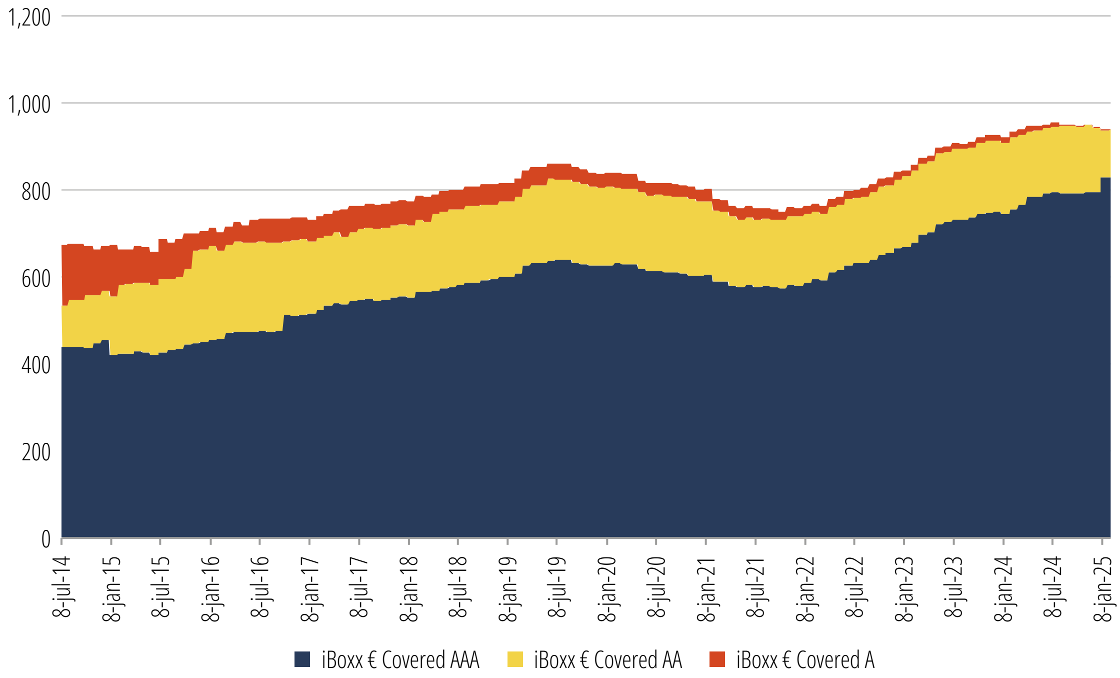
Source: Markit and EBA calculations.

Figure 58: Credit spreads between iBoxx EUR Covered/RMBS Indexes and sovereign rates by country, January 2014 to December 2024, basis points



Source: Markit and EBA calculations.

Figure 59: iBoxx EUR Covered Indexes by rating, July 2014 to December 2024, billion euro



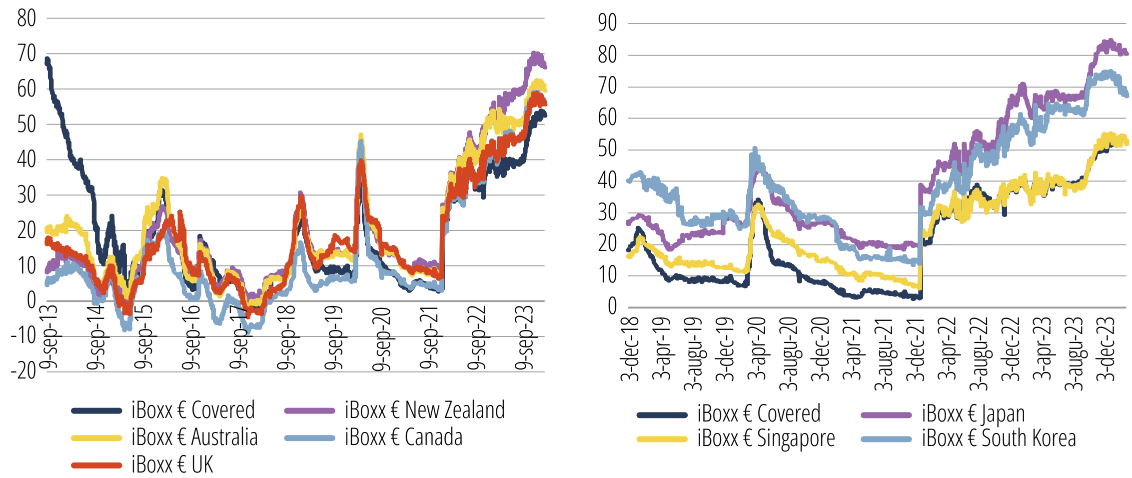
Source: Markit and EBA calculations.

15.11 Third country equivalence covered bond regime

This section collects and assesses comparative data on the performance of covered bond markets in significant third country markets. The EBA shows the spreads of the relevant third country markets and compare those spreads with the relevant index for the covered bond market in the euro area.

In this sense, third country covered bond markets are generally perceived as riskier by investors, evidenced by higher asset swap spreads for them compared to the spread observed for the covered bond market in the euro area (Figure 60).

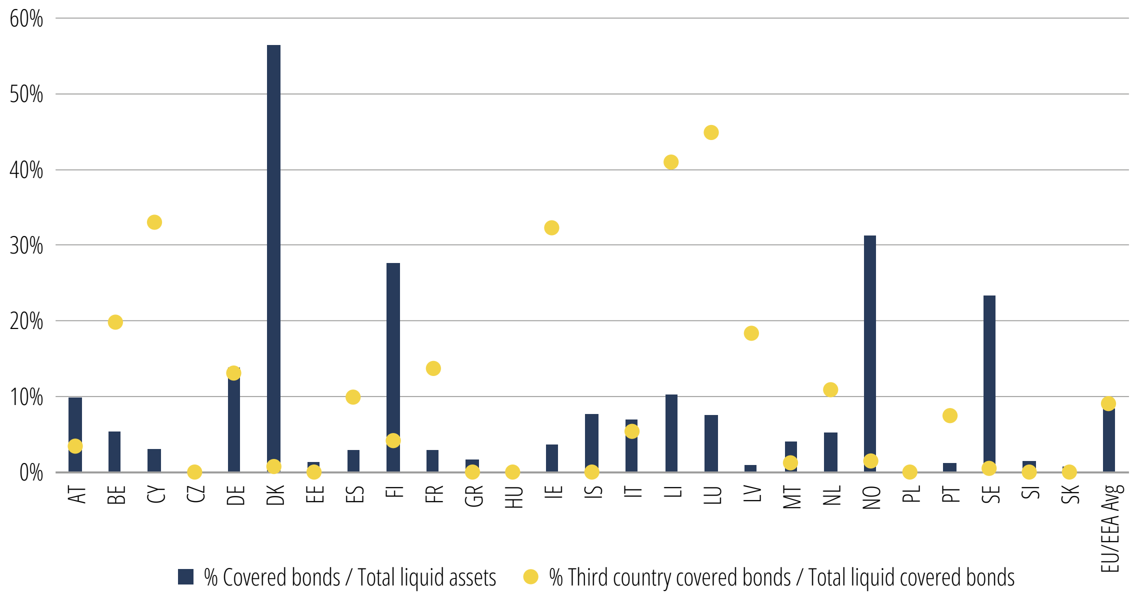
Figure 60: Asset swap spreads (ASW) of iBoxx for non-EEA covered bonds for different groups of countries, February 2013 (left) and February 2019 (right) to February 2024, basis points



Source: Markit and EBA calculations.

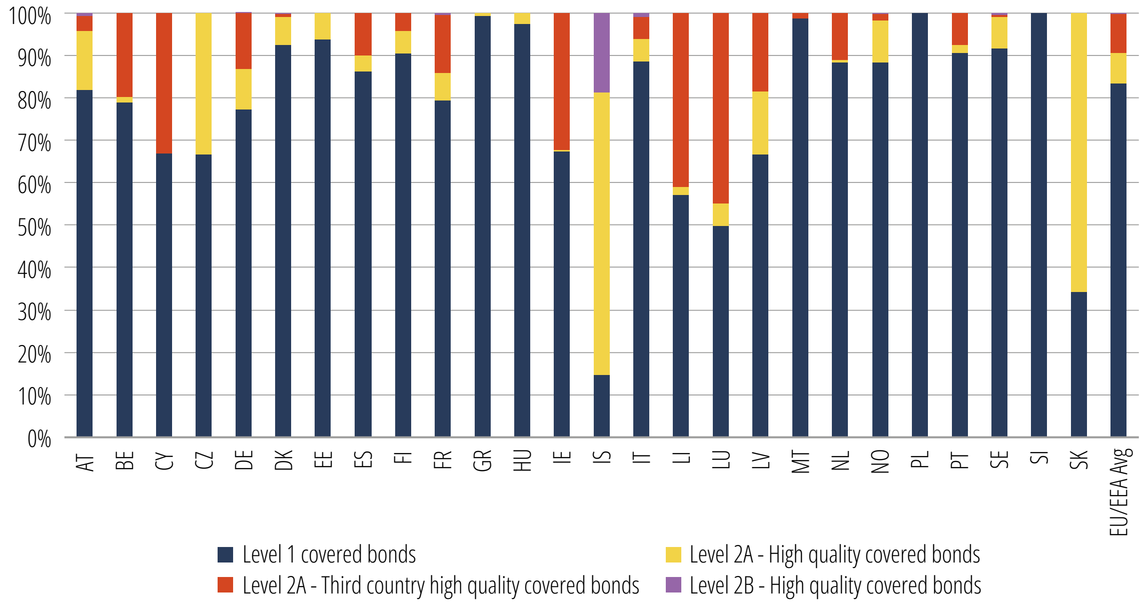
As of December 2024, liquid covered bonds represent 9% of the total stock of liquid assets. The share of third country covered bonds over the stock of liquid covered bonds is 9% (Figure 61). The stock of liquid covered bonds is mainly composed by Level 1 High Quality Covered Bonds (83% of total), Level 2 third country high quality covered bonds (9% of total) and Level 2A high quality covered bonds (7% of total), see Figure 62.

Figure 61: Liquid bonds over the stock of liquid assets and share of liquid third country covered bonds over total liquid covered bonds, December 2024, percentage



Source: COREP and EBA calculations.

Figure 62: Covered bonds that qualify for high quality covered bonds, breakdown by level under LCR framework and by country, December 2024, percentage



Source: COREP and EBA calculations.

15.12 Liquidity of covered bonds

As a suitable indicator to assess the liquidity of covered bonds, the EBA proposes to include the difference between the maximum and the minimum price of the covered bond index in a 30-day window. The difference widens during crisis periods, showing lower trading activity and a worsened liquidity. Also, wider spreads are observed since the start of the policy rate hiking cycle that started in mid-2022. Apart from the beginning of the policy rate hiking cycle, other measures are also contributing to shrinking liquidity in EU financial markets, including covered bonds. For example, the gradual unwinding of the asset purchase portfolios announced by the ECB in December 2022 is likely to reduce the Euro system excess liquidity by EUR 300–400 billion by the end of 2024. Excess liquidity is also being drained by the maturing TLTRO debt.

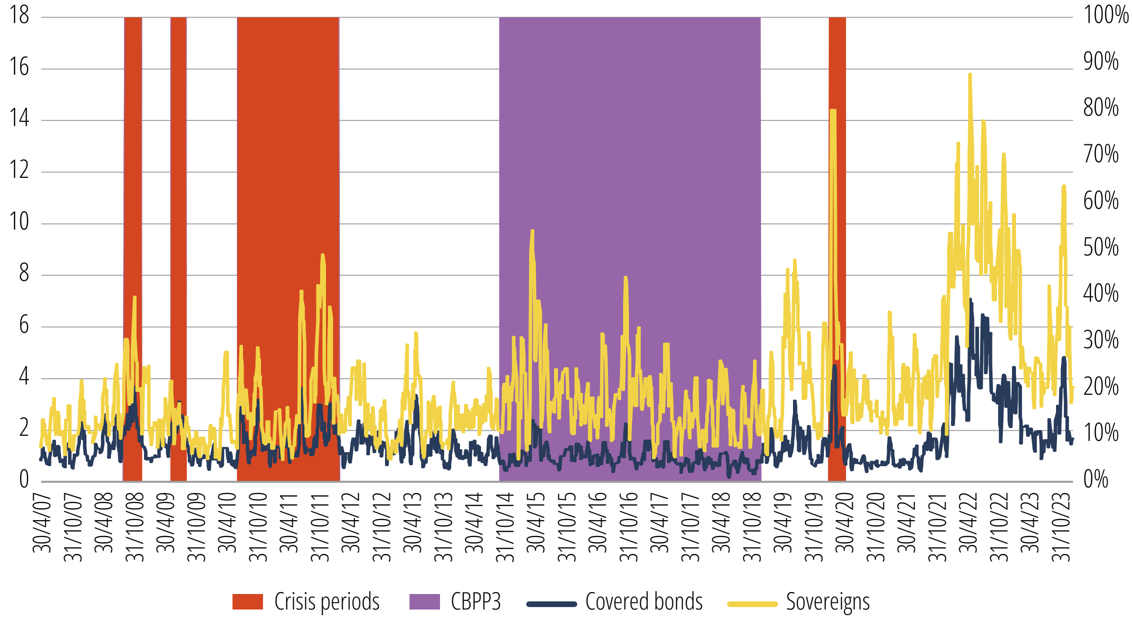
Throughout the period (2007–2023), covered bonds show stronger liquidity than other comparable instruments such as sovereigns, evidenced by a lower spread.

The differentials between the indicator for covered bonds and the one for sovereigns was tight during the 2007–2008 crisis but widened during the CBPP3 undertaken by the ECB between 20 October 2014 and 19 December 2018 and widened further during the COVID-19 pandemic and the monetary policy tightening period that started in July 2022.

During 2022 and 2023, the issuances of covered bonds showed historical maximums (Figure 63), likely underpinned by a strong investor appetite on this type of instrument. This investor perception is also visible in the trading activity, which shows a lower spread between the maximum and the minimum price for covered bonds with respect to sovereigns. The differential on the spread of covered bonds compared to sovereigns has widened during 2022–2023 compared to previous periods, evidenced by a strong trading activity and a high number of trades in markets for covered bonds.

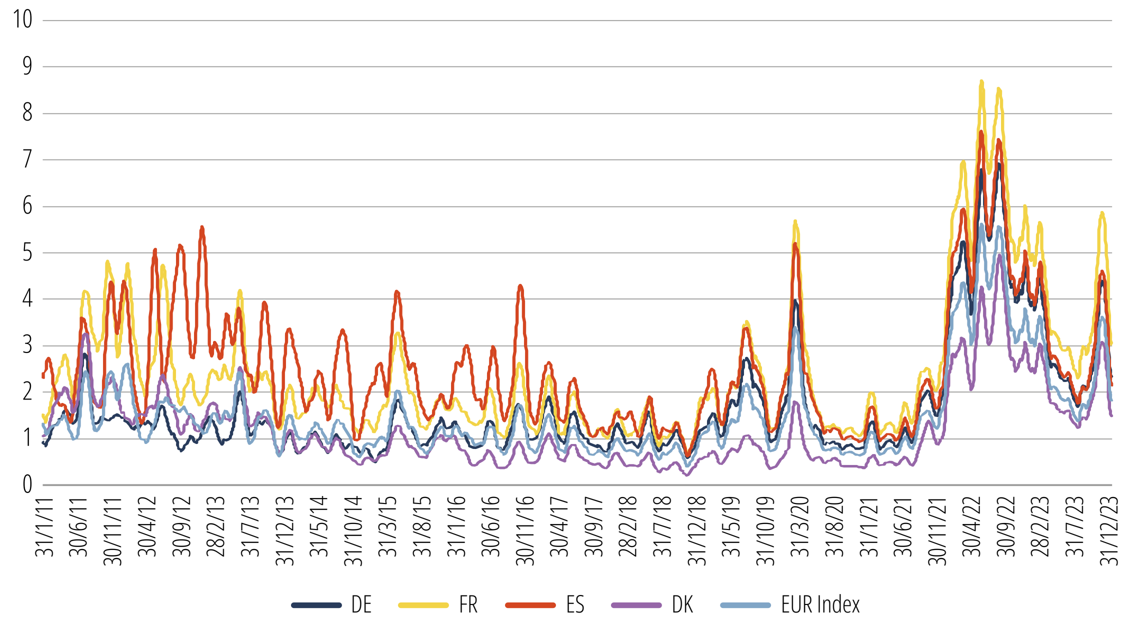
The liquidity of covered bonds is heterogeneous across different EU covered bond markets (Figure 64). While Denmark shows a spread between the maximum and the minimum price below the level of the EUR index, Germany remains slightly above, and France and Spain are well above the level observed for the EUR index. The difference between the country with the lowest level of the indicator and one of the countries that remains above the EUR index widens in crisis periods or periods of high volatility (e.g. COVID-19 crisis), and tightens in periods of high levels of liquidity in the covered bond market (e.g. CBPP3 that took place in the period 2014–2018), see Figure 65.

Figure 63: Difference between the maximum and the minimum price of the Bloomberg EUR covered bond index in a 30-day window compared to other instruments, May 2007 to October 2023, basis points



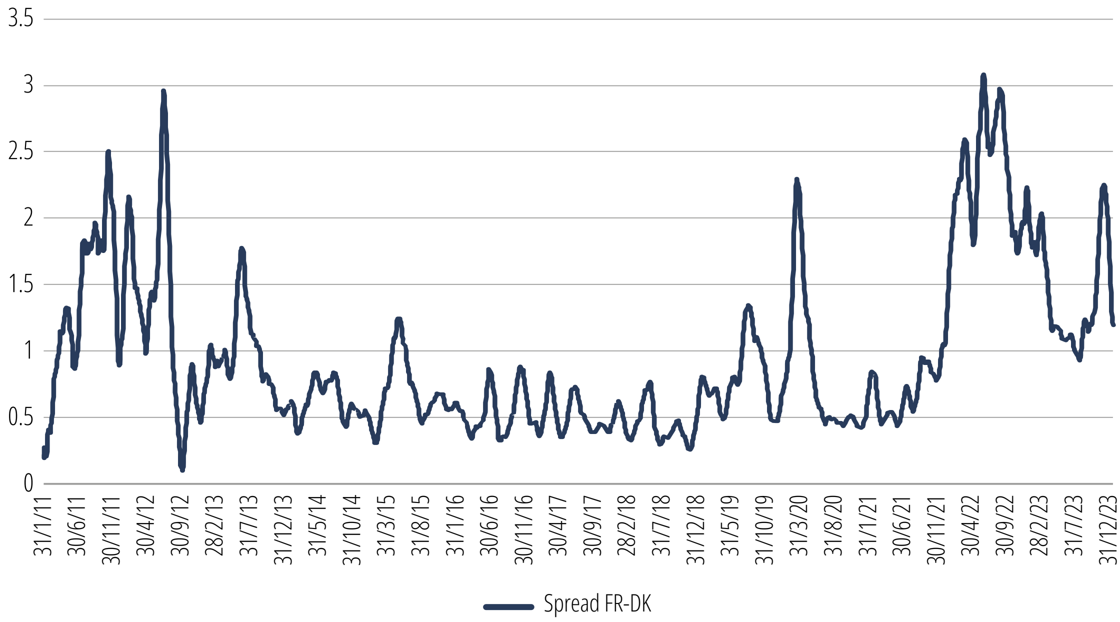
Source: Bloomberg and EBA calculations.

Figure 64: Difference between the maximum and the minimum price of the covered bond index in a 30-day window by country, February 2011 to December 2023, monthly average of the indicator, basis points



Source: Bloomberg and EBA calculations.

Figure 65: Difference between the liquidity indicator of FR and DK covered bonds (see above) based on the covered bond index in a 30-day window for each country, January 2011 to December 2023, monthly average of the indicator, basis points.



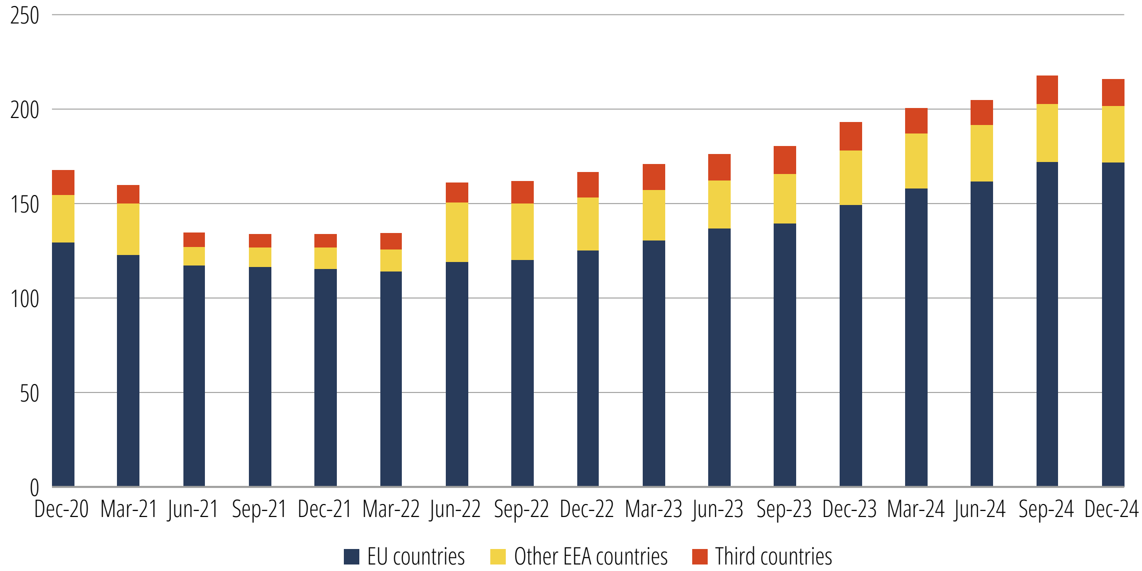
Source: Bloomberg and EBA calculations. The liquidity indicator is the difference between the maximum and the minimum price.

15.13 Covered bonds subject to preferential risk weight treatment

Data on banks' holdings of covered bonds on the asset side have been obtained from COREP 9.1.a. Under this reporting template, bonds as defined in Article 52(4) of the Directive 2009/65/EC shall fulfil the requirements of Article 129(1) and 129(2) of the CRR to be classified in the exposure class 'Covered bonds'. The fulfilment of those requirements must be checked on a case-by-case basis. Nevertheless, bonds as per to Article 52(4) of the Directive 2009/65/EC and issued before 31 December 2007, are also assigned to the exposure class 'Covered Bonds' in line with Article 129(6) of the CRR. Under this template, banks report the covered bonds in the asset side by country of issuance.

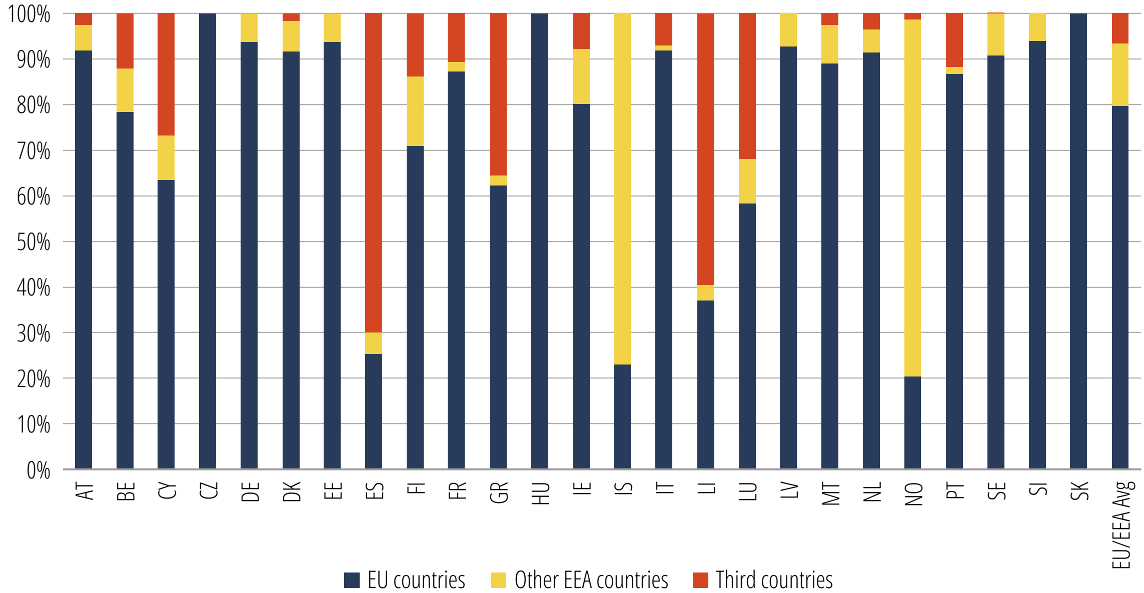
As of December 2024, EU/EEA banks report that third country covered bonds represent 6.6% of the total covered bonds eligible for preferential risk weight treatment. Covered bonds issued in the EU represent 80% of the total covered bonds eligible for the preferential risk weight treatment while covered bonds issued in other EEA countries represent the remaining 14% (see Figure 66). There is a high cross-country heterogeneity in the share of third country covered bonds in the portfolio, from more than half of the total to none (see Figure 67).

Figure 66: Outstanding amount of covered bonds subject to preferential risk weight treatment by jurisdiction of the counterparty, Q4 2020 to Q4 2024, billion euro



Source: COREP and EBA calculations.

Figure 67: Breakdown of the outstanding amount of covered bonds subject to preferential risk weight treatment by jurisdiction of the counterparty and by country, December 2024, percentage



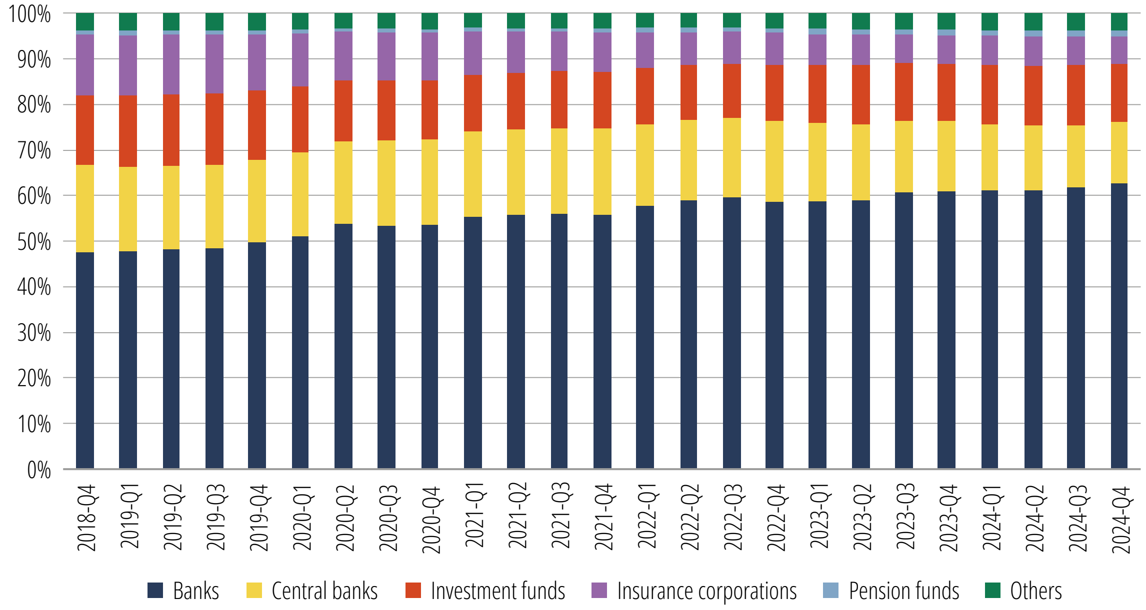
Source: COREP and EBA calculations.

15.14 Investor composition of covered bonds

As of December 2024, banks are the main investors in covered bonds in the euro area, accounting for almost two-thirds of the outstanding amounts, followed by central banks (13%), investment funds (13%) and insurance corporations and pension funds (8%). The remaining 4% is held by other investors (see Figure 68).

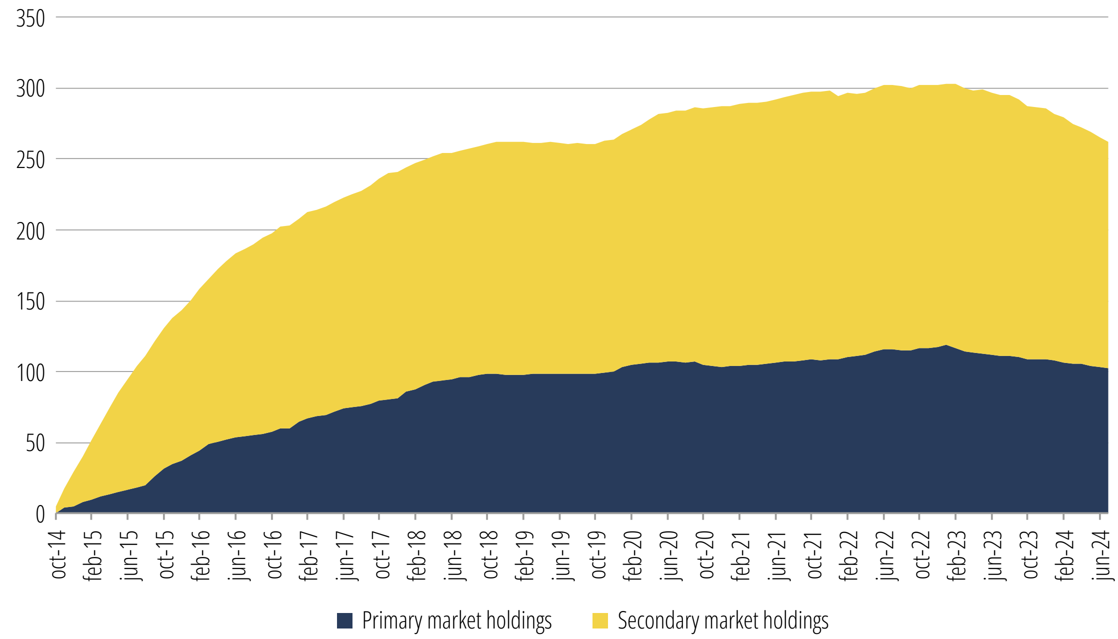
CBPP3impacted substantially on the composition of the covered bond investor base, the share of central banks reaching 19% as of December 2021, equivalent to EUR 298 billion worth of covered bonds in accordance with ECB data (see Figure 69). However, following the gradual unwinding of the asset purchase announced by the ECB in December 2022, central bank's holdings started to decrease.

Figure 68: Composition of the investor base in covered bonds (euro area exposures), Q4 2018 to Q4 2024, percentage



Source: ECB and EBA calculations.

Figure 69: CBPP3 holdings of covered bonds (euro area exposures), October 2014 to June 2024, trillion euro



Source: ECB and EBA calculations.

15.15 Financial stability considerations related to covered bonds

Relative to the overall balance sheets of the EU banks, the total outstanding amounts of covered bonds and securitisation are small. As of December 2023, the total outstanding funding of the two instruments represented 5.4% and 0.4% of the total balance sheets respectively. Covered bonds are the fourth most important funding source, well below deposits (63.1% of the total balance sheet), other debt securities issued (12.1%) and derivatives (4.6%).

To put things in perspective, as of December 2023, commercial banks in the U.S. funded 75% of their balance sheet with deposits, 10% with other borrowings and 4% with other liabilities. ([422]) The share of 'other borrowings' in the balance sheet is below the share of covered bonds and other debt securities for EU banks. Therefore, the U.S. covered bond market is less relevant in relative terms compared to the EU covered bond market.

The difference between the value of covered bond funding showed in this section and the metric of covered bond funding showed in Figure 33 is explained by the different sources used, as data included in Figure 74 are based on FINREP for a sample of 419 banks while those included in Figure 33 are based on asset encumbrance templates for a sample of 2,748 banks (Figure 36).

In terms of the evolution, deposits declined by 2.2% in the period from September 2022 to December 2023 due to TLTRO-3 repayments, which amounted to EUR 503 billion in December 2022 and EUR 498 billion in June 2023. This decline was compensated by an increase in other debt securities issued (2.2% of the total balance sheet) and in covered bond funding (0.8% of the total balance sheet).

Not only covered bond funding is limited in magnitude but also stable over time (Figure 70). Because of this, major financial stability concerns in the event of a crisis or a market turmoil that could eventually dry-up market funding are likely to be negligible.

However, albeit smaller if compared to other sources of funding, the covered bond market deserves a closer look in terms of financial stability considerations under a few side aspects.

A great advantage of the instrument is the possibility to hedge against potential maturity mismatch between assets and liabilities (especially considering the high reliance upon very short-term sources of funding, such as deposits, and the intrinsically long-term nature of real estate mortgages). As a consequence, monitoring fluctuations in the maturity structure of the outstanding volumes of covered bonds is of particular importance.

In the past three years, supply of bonds with relatively short maturity (less than four years) rose to more than 25% of the total, compared to percentages that were negligible before 2022. This increase was primarily at the expense of very long maturity bonds (seven years and above), whose supply shrank to less than 30% in the years 2022-2023, compared to over 50% on average over the past 10 years. On the other hand, medium maturity bonds (five to six years) remained relatively stable. ([423])

While it is true that the general decrease of average maturity in covered bond supply started to revert back to its historical values in 2024, a widespread maturity mismatch across the banking system can still result in a higher liquidity risk upon repayment of the principal, and to interest rate risk in case of the need to issue other bonds for re-financing purposes. This is especially the case in an environment of rising interest rates due to the phasing-out from accommodative monetary policy.

Another possible threat to financial stability in Europe comes from developments in the quality

([422]) Source: Federal Reserve, Assets and Liabilities of Commercial Banks in the United States–H.8.

([423]) Source: HSBC calculations based on Bloomberg data.

of cover pools. A relatively moderate deterioration of the credit quality of the mortgages can severely impact on the stability of the system under certain circumstances, concentration being one of the main concerns. If the real estate mortgage portfolio is very concentrated in a given area (which is often the case for small and medium institutions), fluctuations in housing price can determine variations to loan-to-value ratios, which in turn forces to replace some loans in the cover pool to meet the eligibility requirements for preferential treatment. Concentration can also take the form of too much similarity in the mortgage structure. Reliance on short maturity, floating-rate loans exposes borrowers to repayment risks, which are in turn passed-through the credit quality of the cover pool.

According to recent market research, ([424]) financial stability concerns of such kind, albeit not being widespread at European level, are of a certain importance in Nordic countries (and chiefly in Norway and Sweden), where 75% of dwellings are encumbered by mortgages having characteristics which are similar to those outlined above.

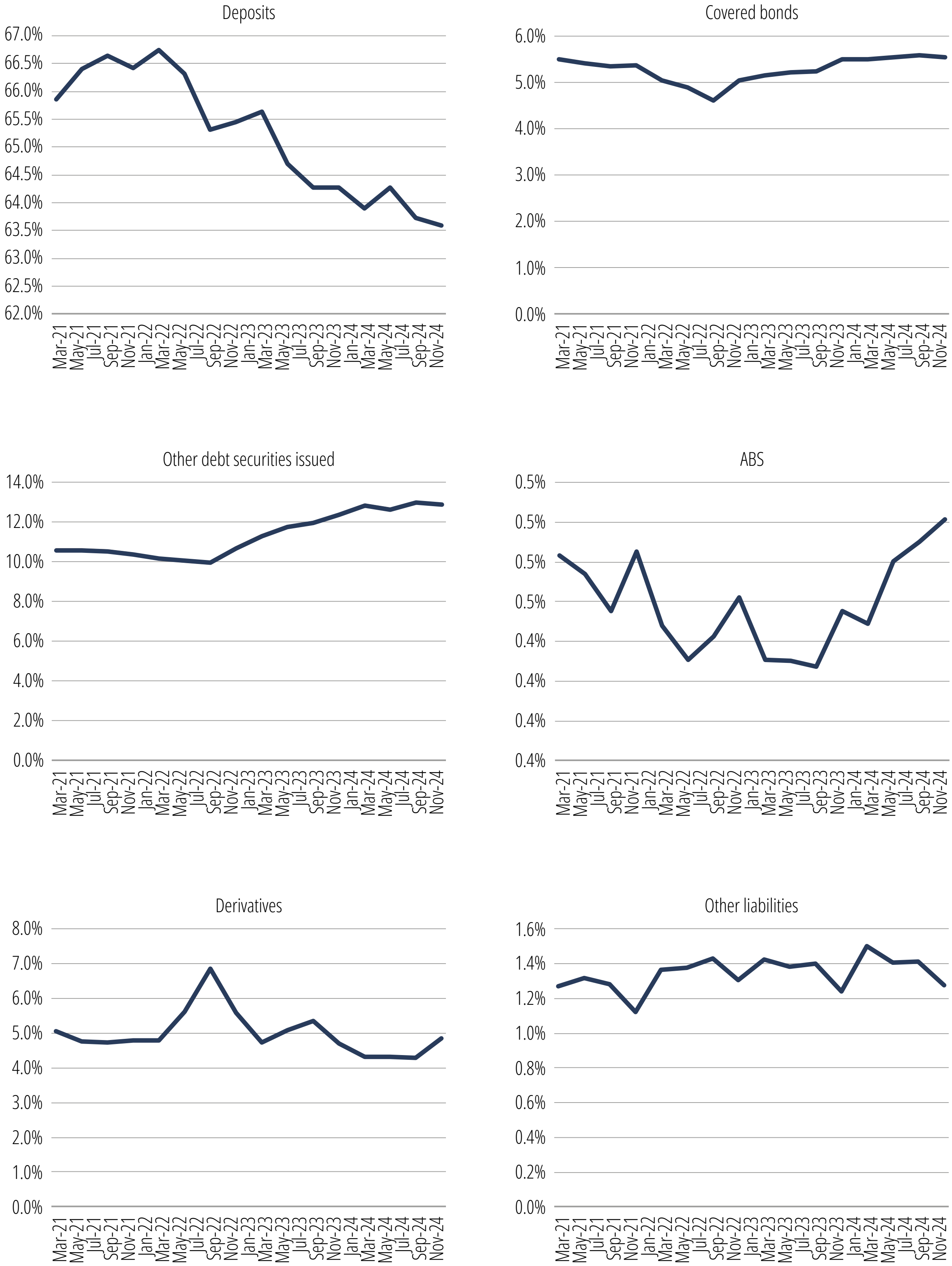
Lastly, research has shown (Ahnert et al. (2016)) ([425]) that high levels of asset encumbrance are associated with a higher risk of bank runs coming from unsecured investors. If the cover pool quality deteriorates, the risk becomes asymmetrically concentrated to unsecured creditors.

To resume, the EBA acknowledges that the European covered bond market remains solid, and that covered bonds constitute a relatively cheaper and safer source of funding, also in view of the small size compared to other sources. Also, asset encumbrance levels have declined in recent years upon TLTRO repayments, even if covered bond funding has slightly increased. Nevertheless, evidence shows that covered bonds are not immune from becoming a possible vehicle of financial fragility.

([424]) Source: Scope Ratings, Covered Bond Outlook 2024.

([425]) A summary of the study is available here.

Figure 70: Evolution of different funding sources as percentage of the total balance sheet for a sample of 419 EU/EEA banks, Q1 2021 to Q4 2024



Source: FINREP and EBA calculations.

15.16 Credit performance of cover pools

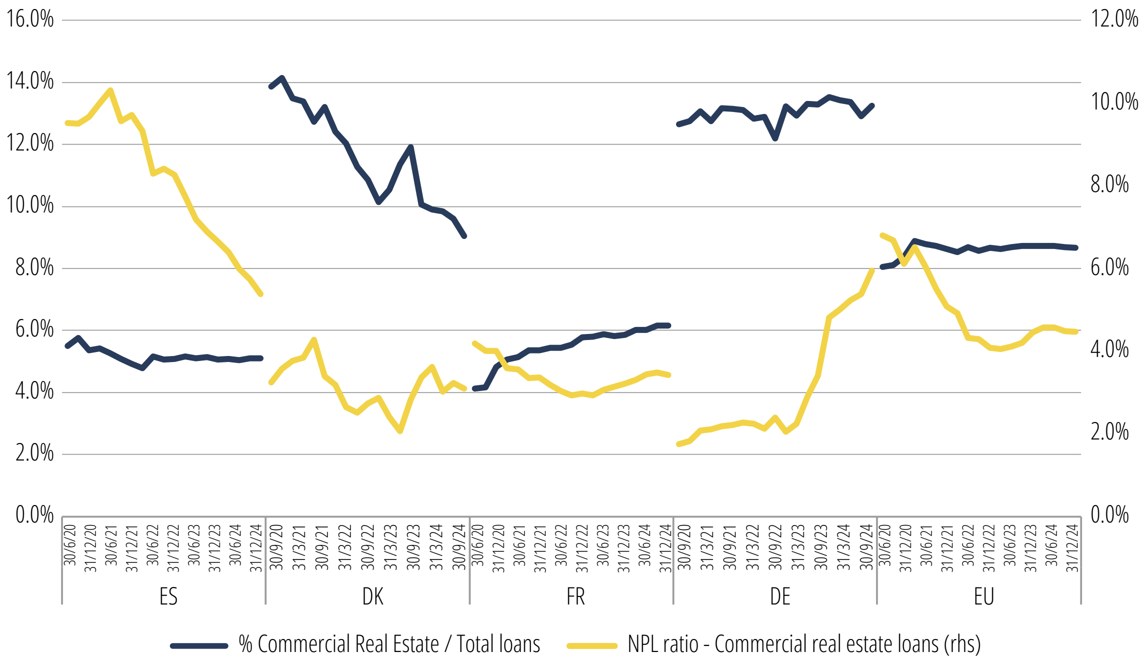
The ratio of non-performing loans of the two main asset classes in the cover pools (RRE and CRE loans, which amount to more than 80% of the EU-wide total cover assets), gauge the overall credit performance. The metrics refer to the total of the EU and the main covered bond markets, which are also those for which these two asset classes represent at least 70% of the cover pool composition.

As of December 2024, the ratio of non-performing CRE loans over all CRE loans (Figure 71) stood at 4.5% for EU/EEA banks and remained stable over the past year but increased by 36 basis points since June 2023. Since December 2023, the ratio at the EU/EEA level remained stable on a yearly basis because of an increase in the non-performing ratio observed in France and Germany compensated by a decline in Denmark and Spain. More precisely, last year Germany experienced a sharp deterioration of the non-performing loans ratio (114 basis points), whilst ate the same time by a decline (126 basis points) Spain experienced a decline (126 basis points).

The upward trend since June 2023 was underpinned by the deterioration of CRE loans in Germany, which showed a sharp deterioration of the non-performing loans ratio of 300 basis points since June 2023. In Denmark and France, CRE loans only represent 9% and 6.2% of the total loans, respectively, whereas in Germany the proportion stands at 13.2% of total loans. The level of the CRE loans in Germany is well above the average for EU/EEA banks (8.7% of total loans as of December 2024) and the deterioration of the credit quality can explain the evolution of the non-performing loans ratio at the EU/EEA level.

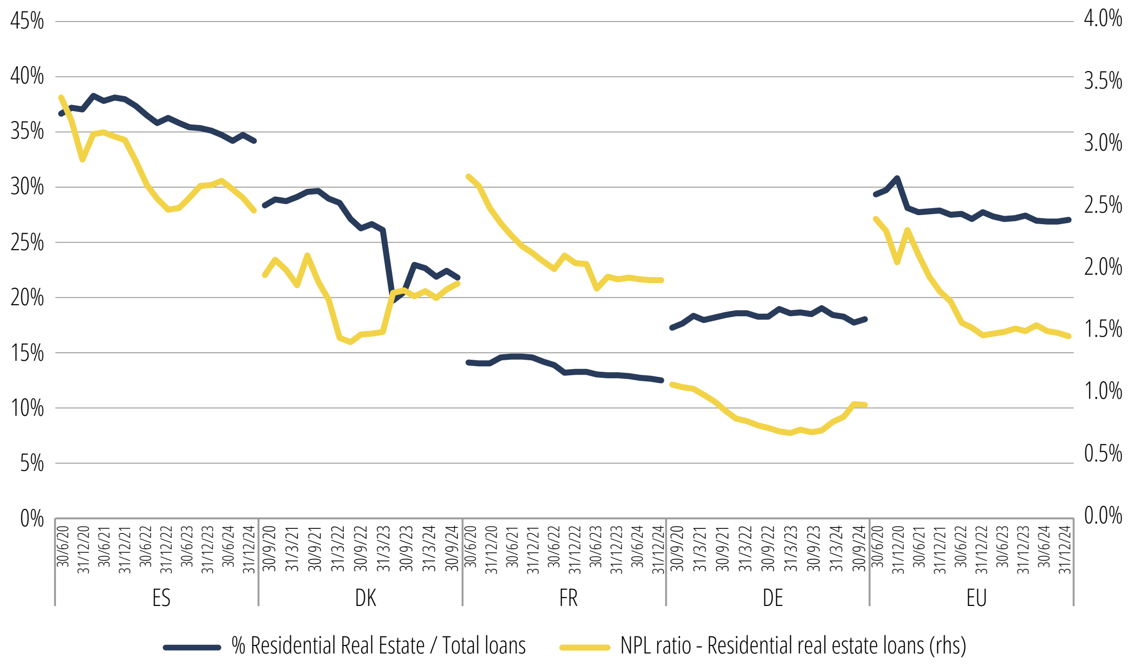
As of December 2024, the non-performing loans ratio of RRE loans stood at 1.5% for EU/EEA banks (Figure 72) and remained stable over the past year. The yearly evolution of the non-performing loans ratio is heterogeneous across countries, increasing in Denmark and Germany, but declining in France and Spain. RRE loans represent 27% of total loans for EU/EEA banks and are particularly significant for Spanish banks (34.2% of total loans), followed by Denmark (21.8%), Germany (18%) and France (12.5%).

Figure 71: CRE loans as percentage of total loans (left axis) and non-performing CRE loans as percentage of total CRE loans (right axis) by country and for the EU, Q2 2020 to Q4 2024



Source: FINREP and EBA calculations.

Figure 72: RRE loans as percentage of total loans (left axis) and non-performing RRE loans as percentage of total RRE loans (right axis) by country and for the EU, Q2 2020 to Q4 2024



Source: FINREP and EBA calculations.

15.17 Additional data

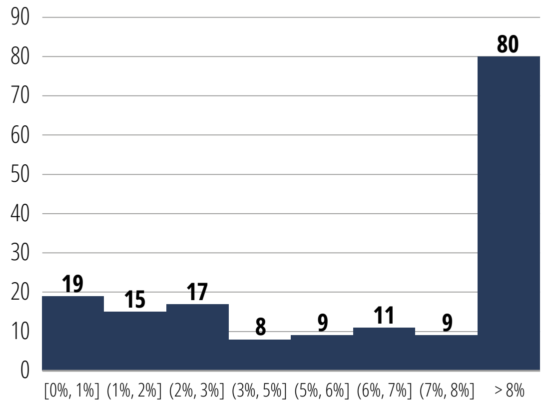
Figure 73: Sample of EU banks used in the analysis of the average levels of covered bond liabilities, December 2024

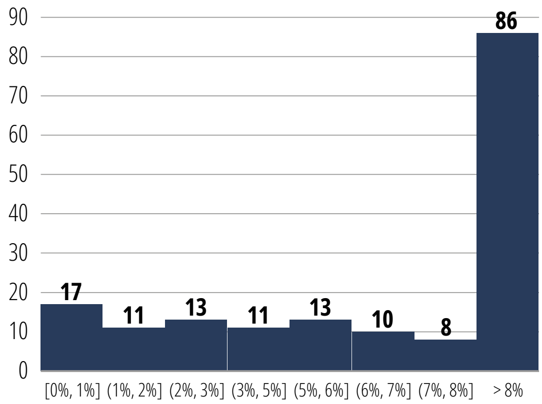
	Consolidated reporting		Individual reporting	
Country	**Total Sample**	**Only covered bond issuers**	**Total Sample**	**Only covered bond issuers**
AT	337	21	395	25
BE	19	4	29	5
BG	11	0	17	0
CY	7	0	10	0
CZ	14	0	27	5
DE	1187	62	1210	63
DK	49	4	57	7
EE	7	1	8	1
ES	67	11	67	8
FI	11	8	44	7
FR	85	8	67	5

	Consolidated reporting		Individual reporting	
Country	**Total Sample**	**Only covered bond issuers**	**Total Sample**	**Only covered bond issuers**
GR	14	1	14	1
HR	12	0	20	0
HU	8	1	26	2
IE	14	2	19	2
IS	11	1	11	1
IT	126	9	352	12
LI	10	0	11	0
LT	14	0	15	0
LU	49	0	72	2
LV	6	0	8	0
MT	16	0	17	0
NL	28	9	28	7
NO	43	13	133	13
PL	505	3	519	4
PT	26	2	37	4
RO	10	0	24	1
SE	52	8	63	10
SI	6	0	12	0
SK	4	1	11	4
Total	**2748**	**169**	**3323**	**189**

Source: COREP and EBA calculations.

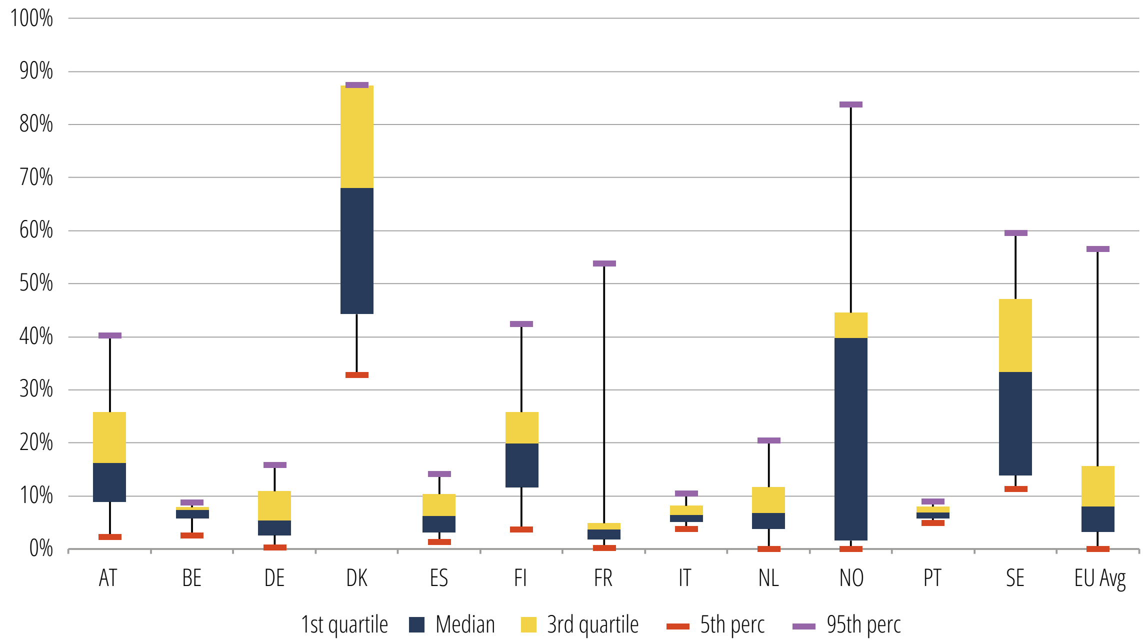
Figure 74: Distribution of covered bond funding of EU banks as percentage of their total assets, by number of banks issuing covered bonds, December 2024, consolidated reporting data (left) and individual reporting data (right)





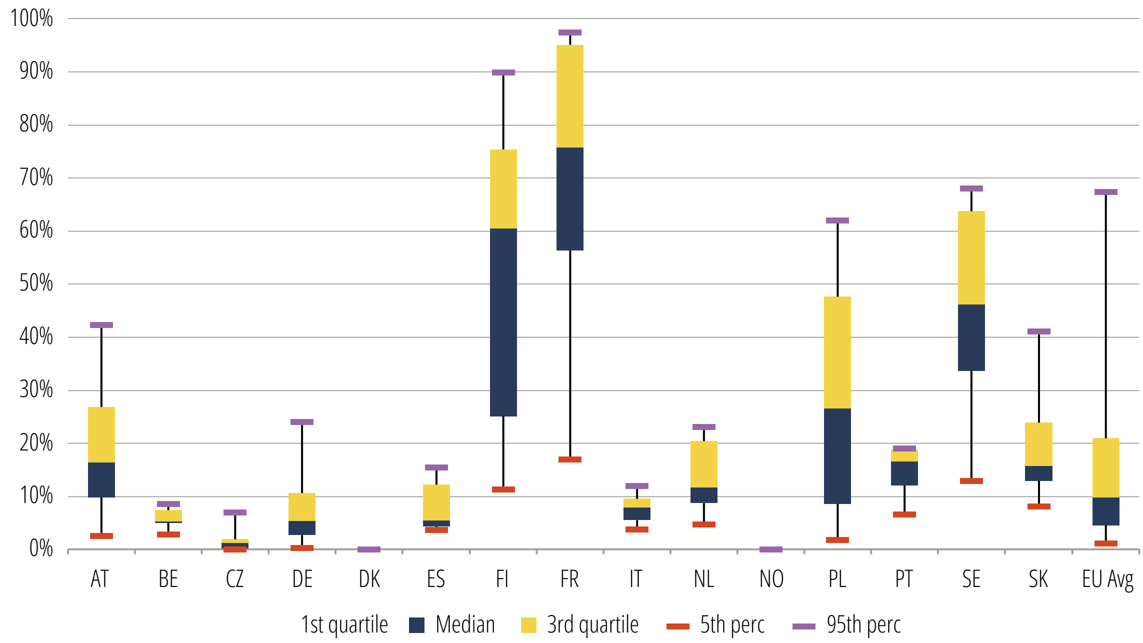
Source: FINREP and EBA calculations.

Figure 75: Distribution of covered bond funding of EU banks as percentage of their total assets, by country, December 2024, consolidated reporting data



Source: FINREP and EBA calculations.

Figure 76: Distribution of covered bond funding of EU banks as percentage of their total assets, by country, December 20024, individual reporting data



Source: FINREP and EBA calculations.

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