

EMF | ECBC

EUROPEAN MORTGAGE FEDERATION
EUROPEAN COVERED BOND COUNCIL



ECBC GLOBAL CONCEPT NOTE ON THIRD COUNTRY EQUIVALENCE FOR COVERED BONDS

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SECTION I. INTRODUCTION

By the **EMF-ECBC Secretariat**, **Colin YS Chen** – DBS Bank & Chairman of the ECBC Global Issues Working Group and **Christopher Walsh** – Clifford Chance

AN INDUSTRY CONCEPT NOTE ON THIRD COUNTRY EQUIVALENCE FOR A GLOBAL IMPLEMENTATION OF THE COVERED BOND DIRECTIVE

The implementation of the Basel Committee on Banking Supervision's (BCBS) framework, together with a common legislative Directive on Covered Bonds in the 30 countries of the European Economic Area (EEA), is radically revolutionising the Capital Markets Infrastructure of the Old Continent, providing new common crisis management tools for policy makers and market participants, and an efficient financial asset to support the real economy whilst facilitating the transition to a greener world. For over 250 years, covered bonds have proven to be an efficient debt instrument enabling banks to mobilise private sector means and capital towards long-term investment with a wide public benefit and issue real estate loans and public-sector debt. During the years of market turmoil at the beginning of the 21st century, covered bonds demonstrated a strong degree of resilience. Throughout the crisis, they played a pivotal role in bank wholesale funding, providing lenders with a cost-effective and reliable long-term funding instrument for mortgage and public-sector loans. The Industry continues to build on the lessons learnt from the financial crisis while maintaining a focus on the essential features and qualities that have made the covered bond asset class such a success story.

Today, the ongoing energy crisis and the need to renovate the housing building stock are now, more than ever, opening up new frontiers for housing finance and covered bonds at both EU and international levels. Moreover, with the adoption of the Covered Bond Directive in the European Economic Area, further clarity as to what a covered bond is has also been achieved. The covered bond financing instrument is being exposed to critical evolutions which may bring about both new opportunities and new risks. The covered bond market is faced with new regulatory, policy and supervisory developments, while market innovation, the continuous process of globalisation and national implementation of the covered bond concept will also leave their mark on the asset class.

With the approval in Morocco of the first African Covered Bond law in September 2022, four continents have now introduced covered bond frameworks, a development which is opening perspectives for the development of a new investor base at the global level. The third country equivalence regime of the Covered Bond Directive represents an opportunity to harmonise the policy landscape and reinforce the regulatory treatment of the asset class from a prudential perspective. In parallel, the Covered Bond Label has already helped enormously in harmonising the covered bond landscape, particularly in the area of disclosure, and provides a unique quantitative database and qualitative benchmark, with more than €2 tr. of bonds outstanding at global level.

In view of these considerations, the covered bond industry firmly believes that, in any evolution, there is a clear need to preserve the key nature of

the product as a crisis management tool rooted in robust qualitative and macroprudential characteristics, which are the basis for ensuring a regulatory recognition at global level.

ROLE OF THE ECBC GLOBAL ISSUES WORKING GROUP

To develop synergies between traditional, new and emerging covered bond markets, and join forces to develop of a more level playing field for all at a global level, in 2015 the European Covered Bond Council (ECBC) established its Global Issues Working Group (GIWG). To date, the work undertaken by the GIWG has been instrumental in ensuring a proper recognition of the macroprudential value of the covered bond asset class while securing an appropriate, homogenous and cross-border regulatory treatment by different jurisdictions at a global level. In September 2022, the ECBC Steering Committee mandated the GIWG to elaborate a concept note on third country equivalence, to act as a roadmap helping global authorities and stakeholders in aligning policy and market best practices around the Covered Bond Directive.

To this end, ECBC members have identified an important role to be played by the Working Group as a discussion forum for exchanging market best practices and as an educational platform for issuers and global investor communities. The overarching aim of the Working Group is to enhance transparency and convergence, and to ensure that there is a progressive common understanding of the covered bond concept, with similar market solutions and infrastructures, and more importantly, comparable regulatory treatment. In this context, the Working Group has been looking into the following topics via dedicated topical Work Streams:

POLICY DEVELOPMENTS

Looking back over recent years, it is clear that the covered bond space has been fundamentally impacted by major waves of monetary policy, supervisory review and regulatory change, which are having significant consequences for the long-term financing and housing finance sectors.

At EU level, for example, the Capital Markets Union (CMU) initiative, which is intended to ensure the capability of the financial services sector to support the growth agenda and provide long-term financing to the real economy, has identified the following areas of reflection:

- Striking the right balance, in terms of a level playing field, between international banks operating in the European Union and European actors operating both internationally and domestically.
- Carefully examining the market impact of several key regulatory developments and trying to secure the European banking pillars in the Basel Committee debates (i.e., Net Stable Funding Ratio (NSFR), risk weighting, capital floors framework, leverage ratio).

- The role of European lenders in the framework of housing and of small and medium sized enterprise (SME) financing, and lending to the real economy is becoming increasingly multi-faceted.
- The role of covered bonds and the Industry's firm commitment to achieve a higher degree of harmonisation, in line with EU objectives and market preferences.
- Developing energy efficient mortgages and green covered bonds for the benefit of EU citizens and the environment

Moreover, at the end of 2019 the EU adopted the Covered Bond Legislative Package, comprising a Covered Bond Directive and a Regulation amending Art. 129 of the Capital Requirement Regulation, namely the article focusing on covered bonds. The Directive entered into force on 8 January 2020 and became fully effective on 8 July 2022. Throughout the 18-month implementation period, which brought both new risks and new opportunities to covered bond markets at European and more global levels (see section III for a more detailed analysis), the ECBC remained – and remains today – committed to ongoing and regular liaison with the EU institutions regarding this key piece of legislation.

MARKET DEVELOPMENTS

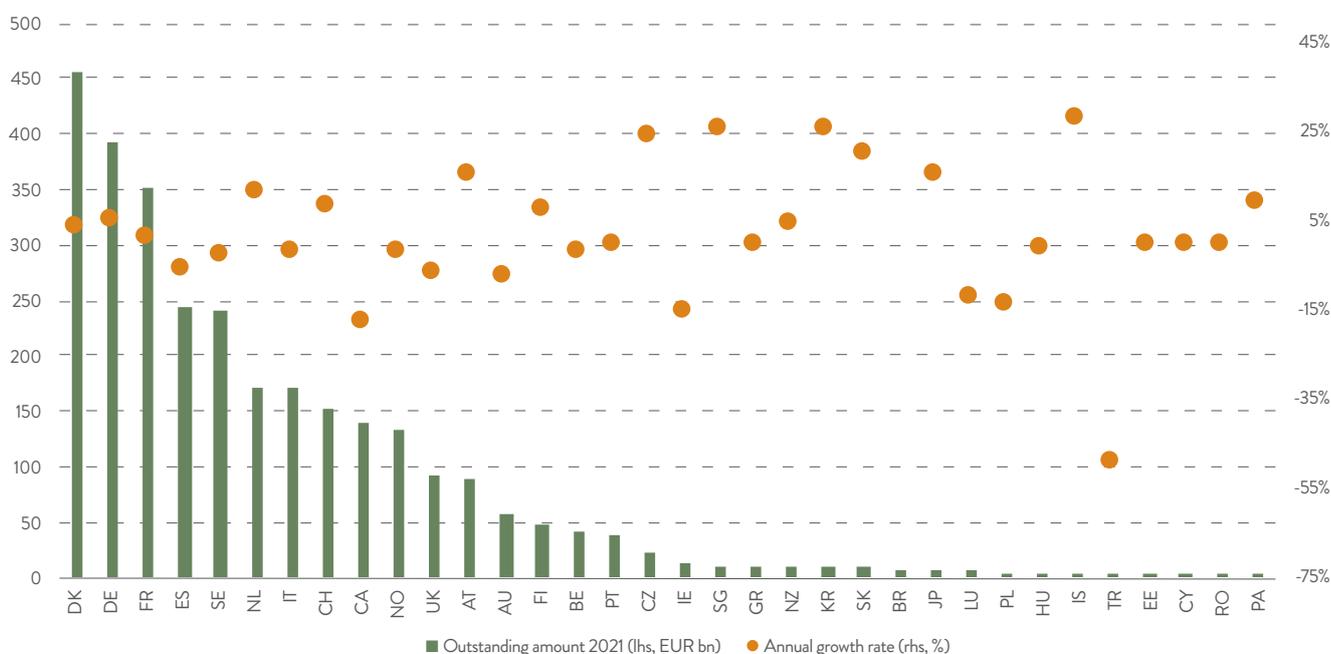
Covered bonds sit at the heart of the European financial tradition, having played a central role in funding strategies for the last two centuries. The strategic importance of covered bonds as a long-term funding tool is now

recognised at a global level. In this context, Armenia, Australia, Brazil, Canada, Morocco, New Zealand, Singapore, and South Korea have implemented covered bond legislation in recent years. Major jurisdictions including Chile, India, Japan, Mexico, Panama, Peru, South Africa and the United States, are either in the process of adopting covered bond legislation or are investigating the introduction of covered bonds.

The outstanding amount of covered bonds rose by EUR 31 bn. to EUR 2.94 tn. at the end of 2021. This was the fourth consecutive year of growth and set a new record, taking over from 2020. However, the pace of growth in the amount outstanding slowed to 1.1% in 2021, down from 7.4% and 5.1% growth in 2020 and 2019, respectively. In contrast to 2020, the increase largely stemmed from issuance of publicly placed covered bonds (+EUR 32 bn.) in 2021, with issuance of privately placed covered bonds (which includes retained covered bonds) declining by EUR 1.3 bn. This clearly reflects that, in 2021, banks started to rely more heavily on capital market funding, rather than cheap central bank borrowings offered after the outbreak of the COVID-19 pandemic. Overall, the figures once more underline the significant importance of covered bonds as bank funding tool around the globe.

The top five countries ranked by size of outstanding covered bonds (see Figure 1) in 2021 remained unchanged from 2020, with Denmark (EUR 455 bn.) retaining the top spot, followed by Germany (EUR 391 bn.), France (EUR 350 bn.), Spain (EUR 243 bn.) and Sweden (EUR 242 bn.).

FIGURE 1 | TOTAL AMOUNT OF OUTSTANDING COVERED BONDS BY COUNTRY AND ANNUAL CHANGE END 2021

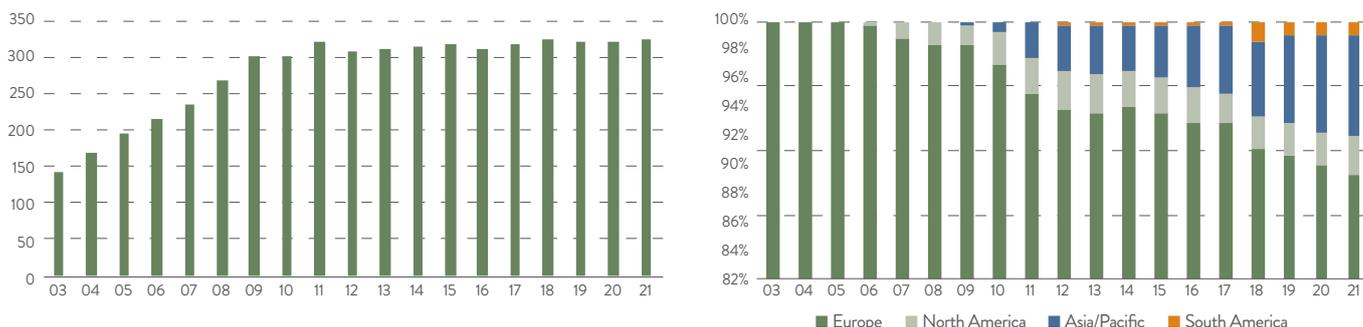


Source: ECBC Fact Book 2022, ABN AMRO (growth rate of Brazil is 138%, not shown in graph)

At the end of 2021, 326 covered bond issuers were active around the globe (see Figure 2). The regional breakdown (see Figure 3) shows that the majority (88%) of all 326 issuers are located in Europe, while the share of the Asia/Pacific-based issuers rose to 7.7% last year (2020: 7.4%). The share of North

America-based issuers rose by 0.6% to 3.1%, while that of South America-based issuers remained roughly stable at 1.2%. This being said, it is worth noting that the volume of South American covered bonds outstanding more than doubled in 2021 compared to 2020, mainly driven by Brazilian banks.

FIGURE 2-3 | NUMBER OF COVERED BOND ISSUERS (LEFT) AND THEIR REGIONAL SHARE (RIGHT)



Source: ECBC Fact Book 2022, ABN AMRO

COVERED BOND LABEL

The firm commitment to contribute to European efforts to enhance financial stability and transparency led the covered bond industry to launch a quality label in 2012. The Covered Bond Label was developed by the European issuer community – led by the ECBC – working in close cooperation with investors and regulators, and in consultation with all major stakeholders such as the European Commission and the European Central Bank. The Covered Bond Label and its transparency platform (www.coveredbondlabel.com) went live January 2013, providing detailed covered bond market data, comparable cover pool information and legislative details on the various national legal frameworks designed to protect bondholders. As of January 2023, 165 labels have been granted to 126 issuers from 24 countries, covering over EUR 2.07 tn. of covered bonds outstanding, where over 5,400 covered bonds include information on the Liquidity Coverage Requirement (LCR), maturity structures, regulatory treatment, etc.

In this context, covered bond issuers from these 24 different jurisdictions have come together to develop a Harmonised Transparency Template (HTT). Since 2016, the HTT has been providing cover pool information in a harmonised format, which allows for both the recognition of national specificities, with the National Transparency Tabs, and the comparability of information required to facilitate investors’ due diligence. In particular, to proactively align with the requirements of the Covered Bond Legislative Package, in September 2022 the Covered Bond Label published an updated HTT, fully aligned with Art. 14 of the Covered Bond Directive. Additional country-specific information on the covered bond programmes can be found in the National Transparency Templates often included in the HTT.

The critical mass achieved by this initiative (over 70% of covered bonds outstanding globally now hold the Label) is a clear sign that the Industry recognises the need to respond to the requirements of new classes of investors by providing higher levels of transparency to aid investment decisions. In this context, it is important to highlight that at present five non-EEA countries (Australia, Canada, Singapore, South Korea and the UK) in aggregate hold 32 labelled cover pools, linked to 453 covered bonds, which account for over EUR 297 bn, equivalent to 61% of the non-EEA covered bond market share.

LOOKING AHEAD

The Industry has demonstrated its capacity to drive innovation and implement global transparency benchmarks through market initiatives such as the Covered Bond Label and the European Secured Note (ESN) instrument. More importantly, this community, by acting as a market catalyst has facilitated investors’ compliance with their due diligence obligations and provided a key contribution in the building of the Capital Markets Union in Europe. This market principle-based approach, in parallel with the introduction of the Covered Bond Directive, has shown that it is possible to build, from the bottom-up, proposals based on market consensus to initiate pan-European solutions that enhance transparency, comparability, convergence of markets and best practices. Taking stock of where we have come from, where we are now and where we are heading, it is clear that the market and the environment in which it operates is constantly evolving and, as such, the work of the ECBC and its Global Issues Working Group is always in progress. This provides us with an ongoing challenge, and we believe that the ECBC initiatives currently underway will help further strengthen the asset class and facilitate the convergence of market and supervisory best practices.

In line with the ever-growing importance of sustainable finance, the covered bond industry has embraced the urgency and challenges of this issue, and, at the time of writing, the Covered Bond Label is held by 89 sustainable covered bonds, collectively worth over EUR 61 bn. and registered across a variety of jurisdictions. Moreover, to provide more asset-related information for labelled covered bonds which are flagged as sustainable, starting from Q1 2023 labelled issuers will be requested to complete the F1 Tab of the Label’s Harmonised Transparency Template (HTT), which is specifically dedicated to sustainable mortgages in the cover pool. The challenges that lie ahead in this area are characterised by agreeing on a shared set of definitions to define “sustainable” and the specific ESG criteria for the underlying assets in the cover pool.

The ongoing harmonisation of the covered bond asset class at both EU and now also at the global level represents a new era for the Industry. In conjunction with these, market conditions, political and environmental developments and new trends are all impacting and shaping the product here and now, and will continue to do so going forward.

SECTION II. MAPPING

The Current State of Play and Outlook for Covered Bonds Outside The European Economic Area

By **Antonio Farina**, S&P Global Ratings, **Ian Stewart**, UK Regulated Covered Bond Council (UK RCBC), **Lily Shum**, Canada Mortgage and Housing Corporation (CMHC), **Filipe Pontual**, Brazilian Association of Real Estate Loans and Savings Companies (ABECIP), **Robert Gallimore**, Australian Securitisation Forum (ASF), **Thomas Cohrs**, Helaba, and **Colin YS Chen**, DBS Bank & Chairman of the ECBC Global Issues Working Group

Covered bonds represent an over EUR 2.9 tn. global asset class. Initially dominated by European issuers, covered bonds are gaining popularity in many other markets, such as Australia, Canada, Singapore and South Korea (see Figure 4).

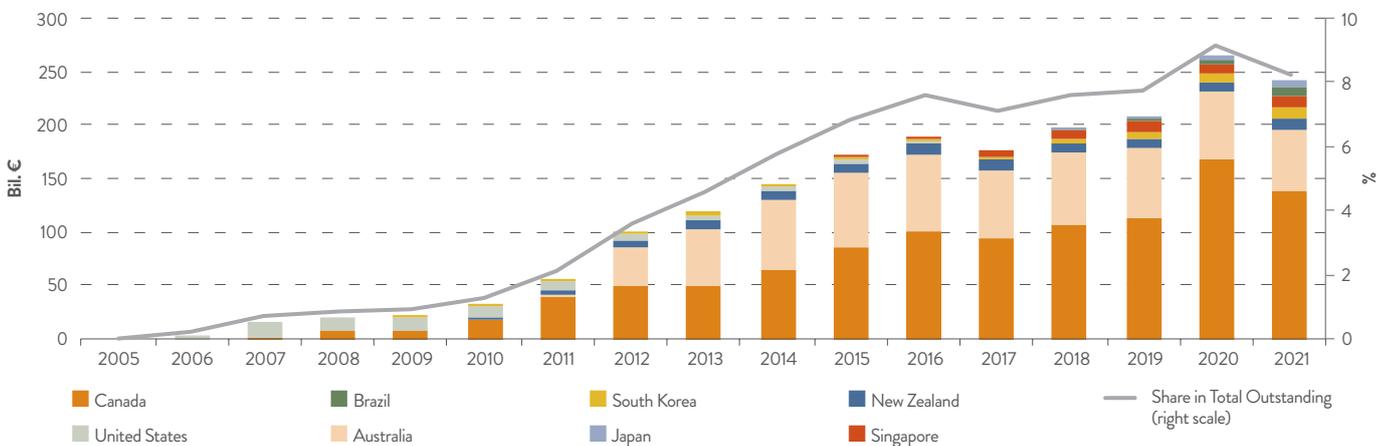
The global financial crisis of 2008 proved that covered bonds can be a resilient source of funding in times of wider market turmoil. Even in the European countries most affected by the crisis, such as Italy and Spain, banks were able to tap the covered bond market despite other sources of wholesale funding evaporating. Issuers and regulators outside the traditional European markets noted banks' ability to issue covered bonds in times of stress and expedited the approval or the amendment of dedicated legislation. Since then, covered bond issuance picked up quickly in most of these countries.

Despite extended COVID-19 containment measures that pushed the world into the deepest recession since the Great Depression of 1929, the covered

bond market remained open throughout 2020 and banks were able to find investors, even at the peak of market turmoil. Cheap central bank funding partly replaced investor-placed covered bonds, but also supported issuance of retained covered bonds. Volumes outside Europe have surged since the second half of 2021, as monetary policy normalisation curtailed issuers' access to cheap central bank funding. Issuance was particularly strong in Canada and Australia, but banks in Singapore, Korea and New Zealand were also active.

Current volatile market conditions, caused by geopolitical turbulence, tightening monetary policies and a deteriorating economic outlook, could further support issuance. Established, highly-rated issuers will probably use their covered bond programmes more, especially if other sources of funding, such as senior unsecured bank debt, become relatively more expensive or difficult to place with investors.

FIGURE 4 | NON-EUROPEAN COVERED BOND MARKETS, OUTSTANDING AMOUNTS



Source: EMF-ECBC



We present here an overview of the major covered bond markets outside the European Economic Area.

BOX 1 | UK MARKET by Ian Stewart, UK Regulated Covered Bond Council (UK RCBC)

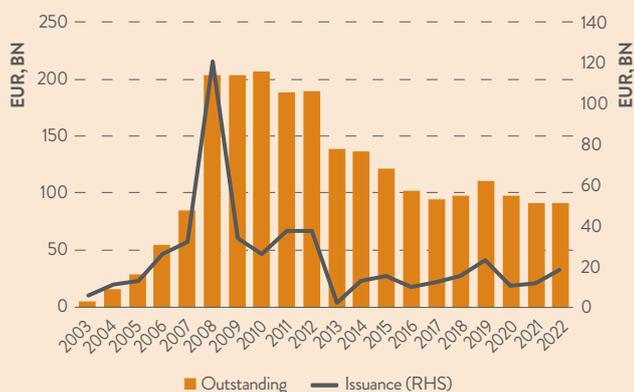
UK

From the first UK covered bond issued in 2003 until the introduction of UK covered bond regulations in March 2008, UK covered bonds were issued under general English law and structured finance principals. The Regulations overlaid the contractual structures and were designed to meet the statutory requirements of the time. The Financial Conduct Authority (FCA) is responsible for the supervision of issuers and programmes, maintains the issuer registry, and has a wide range of enforcement powers. Following the UK's departure from the EU in January 2021 the Covered Bond Directive will not be implemented in the UK until third country recognition is achieved. UK covered bond regulations are closely aligned to the Directive. There are currently 13 UK issuers with regulated covered bond programmes who are all members of the UK RCBC.

Development of Covered Bond Issuances

Initially, outstanding issuances grew rapidly, peaking in 2010 (see Figure 3). Since then, the maturities of early issues have outstripped new issuance and the aggregate balance at the end of 2021 was EUR 88.7 bn. At that time, 41% of all UK covered bonds were denominated in EUR, with GBP making up the majority of the balance at 55% and other currencies representing only 4% of market share. The amount of the market represented by GBP issuance has been steadily growing over recent years as an increasingly deep and efficient wholesale funding source for UK issuers. GBP transactions issued since 2014 are almost exclusively 3–5-year floating rate bonds. Since 2018 this has been based on a compounded daily SONIA rate. The issuances in EUR tend to be fixed rate, with the vast majority in the 5–10-year tenor. For a number of years, all new issuance has been soft-bullet maturities with under 3% of outstanding bonds at the end of 2021 having hard-bullet maturities.

FIGURE 5 | COVERED BONDS ISSUANCE AND OUTSTANDING FIGURES FROM UK ISSUERS, 2003 - 2021, EUR BN.



Source: EMF-ECBC. Please note that this data includes private placements, floating rate covered bonds and self-retained issuances that may have been used to access central bank liquidity.

NORTH AMERICA

Canada represents one of the most successful covered bond markets outside Europe, with over 10% of the entire mortgage market funded by covered bonds. While Canadian banks issue opportunistically in a number of currencies to build a globally diversified funding platform, issuances denominated in Euros represented almost half of total bonds outstanding (see Box 2).

Covered bonds have achieved less success in the **U.S.** No covered bond legislation exists despite several attempts in the post-crisis period. Moreover, the previously issued structured covered bonds have now matured and no US covered bonds are currently outstanding. As long as government-sponsored enterprises such as Fannie Mae and Freddie Mac guarantee most new mortgages, appetite for market-based alternatives such as covered bonds will be minimal.

BOX 2 | CANADIAN MARKET by Lily Shum, Canada Mortgage and Housing Corporation (CMHC)

CANADA

From 2007 until 2012, Canadian covered bonds were issued pursuant to a contractual framework. In 2012 Canada implemented legislation that gives covered bond investors statutory protection. The Canada Mortgage and Housing Corporation (CMHC) is responsible for the administration of the legal framework in Canada and registers issuers and programmes, maintains the issuer registry, and develops and updates the Canadian Registered Covered Bond Programs Guide (CMHC Guide), which specifies the framework requirements. Currently, there are 10 registered covered bond issuers. Through continuous enhancements based on international best practices, CMHC plays an important role in ensuring that a robust, globally recognised legal framework is in place.

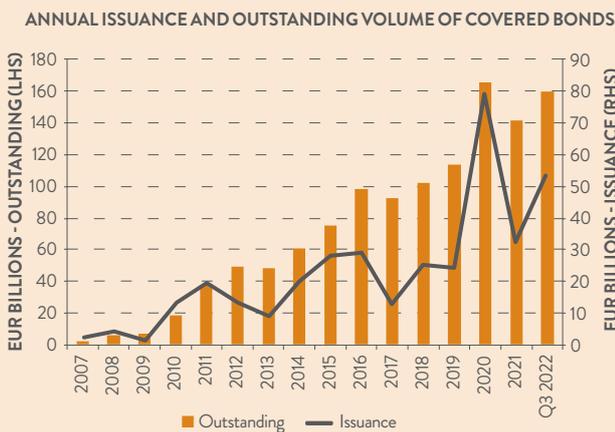
Growth of Covered Bond Issuances

Since the first covered bond issued by Royal Bank of Canada in 2007, outstanding issuances have grown steadily (see Figure 6). Further growth in issuances followed the passage of a dedicated covered bond legislation that established a statutory covered bond regime in Canada. This growth in covered bond issuances since the programme's inception has fundamentally shifted the Canadian banks' wholesale term funding profile.





FIGURE 6 | COVERED BONDS ISSUANCE AND OUTSTANDING FIGURES FROM CANADIAN ISSUERS, 2007 – 2022, EUR BN.



Source: EMF-ECBC

In April 2018, the Government of Canada published the Bank Recapitalisation (Bail-in) Conversion Regulations, SOR/2018-57, under the Bank Act and CDIC Act (Bail-in Regulations). The Bail-in Regulations specify the prescribed shares and liabilities that are eligible for bail-in conversion and their conversion terms. Covered bonds are specifically excluded from prescribed liabilities under the bail-in regulations.

Globalisation, Cross-Markets and Beyond

Canadian issuers remain key participants in international covered bond markets, issuing opportunistically in CAD, EUR, USD, GBP, CHF and AUD markets to build a globally diversified funding platform. The domestic Canadian dollar-denominated covered bond market has also emerged, representing 8% of total outstanding issuances as of Q2 2022. As of mid-2022, EUR-denominated issuances represented 53% of outstanding issuances. The USD and GBP investor base continues to provide important diversification.

CENTRAL AND SOUTH AMERICA

Covered bonds in this region have a short and limited track record. **Panama** saw the first covered bond issuance in 2012. Here, issuance is based on contractual agreements due to the lack of a specific legal framework for covered bonds. Chile is the only other covered bond market in the region, with limited, locally distributed covered bond issuance.

One factor preventing financial institutions in the region from issuing covered bonds is the lack of a dedicated legal framework. However, things are changing thanks to the approval of covered bond regulations in **Brazil** in 2018 and the development of the local market since 2019. If covered bonds prove successful in Brazil, we may see other countries in the region follow its lead, such as Argentina, Peru, Mexico and Colombia.

BOX 3 | BRAZILIAN MARKET by **Filipe Pontual**, ABECIP (Brazilian Association of Real Estate Loans and Savings Companies)

BRAZIL

The main framework of the Brazilian covered bond, the LIG (Letra Imobiliária Garantida), was established by law in 2015. Based on international best practices, between 2017 and 2018 the Brazilian National Monetary Council (CMN) and the Brazilian Central Bank published the secondary legislation and the operational details for LIGs. At the end of 2018, four banks announced local covered bond programmes, and by December 2019, the total outstanding volume of LIGs was BRL 10.2 bn. (approximately EUR 2.3 bn.). Three years later, in October 2022, the total outstanding volume stood at BRL 82.4 bn. (approximately EUR 15.2 bn.), a robust growth of more than 700%.

The main characteristics of Brazilian Covered Bonds are:

- The debt instrument is issued by financial institutions, guaranteed by an asset pool of real estate loans owned by the issuer.
- Asset Pool segregation on the issuer's balance sheet in favour of the covered bond holders is guaranteed by law, including precedence over fiscal and labour claims.
- Minimum overcollateralisation of 5%.
- A fiduciary agent must be appointed to monitor the asset pool quality and represent the note holders' interests should the issuer default.
- Notes and assets within the asset pool must be deposited/registered with a depositary agent authorised by the Brazilian Central Bank.
- LIG programmes must be authorised by the Brazilian Central Bank.
- The law delegates to the National Monetary Council (CMN) and the Brazilian Central Bank the issuance of secondary regulation.
- The CMN Resolution establishes Asset Pool stress testing and minimum liquidity rules.
- The maturity structure is left to the discretion of the Issuers (hard-bullet, soft-bullet or Conditional Pass-Through).

AUSTRALIA AND NEW ZEALAND

Australian banks first issued covered bonds in 2011, following the enactment of legislation and the establishment of prudential guidance and oversight. Banks in New Zealand started issuing covered bonds in 2010 as the statutory regime did not limit the issuance of covered bonds in the same way as the Australian Banking Act.

The Australian Banking Act was amended in 2011 to provide a legislative framework to enable issuance of covered bonds by Australian Authorised Deposit Taking Institutions (ADIs). The Australian Prudential Regulation Authority (APRA) is the prudential supervisor and can, in specific circumstances, give directions in relation to covered bond issuances and the cover pool assets. APRA's Prudential Standard APS 121 Covered Bonds sets out further regulatory requirements in relation to the issuance of covered bonds.

BOX 4 | AUSTRALIAN MARKET by Robert Gallimore, Australian Securitisation Forum and Thomas Cohrs, Helaba

AUSTRALIA

The Australian regulatory framework allows ADIs to issue covered bonds secured up to 8% of an ADI's total assets in Australia. The cover pool can consist of residential or commercial mortgages, which must be beneficially held by a bankruptcy remote covered bond special purpose vehicle. Covered bond holders have dual recourse. First against the issuer and then, following certain trigger events including payment default, against the cover pool assets. The minimum legislative overcollateralisation requirement is 3%. Loan to Value Ratio (LVR) for residential mortgages is capped at 80% and for commercial mortgages at 60%. A cover pool monitor is required to be appointed to each programme to provide an independent oversight of the covered bond programme and the cover pool.

The main characteristics of Australian covered bonds are:

- The debt instrument is issued by an ADI with a guarantee provided by the covered bond guarantor, which is secured by a pool of residential or commercial mortgages.
- Cover pool assets are protected from the claims of other creditors of the ADI legislatively through the Australian Banking Act and through separation of the cover pool of assets from the ADI such that they are set aside and held by the covered bond guarantor, which is a bankruptcy remote special purpose vehicle.
- In addition to the minimum legislative overcollateralisation of 3%, all Australian covered bond programmes share a minimum contractual overcollateralisation of >5%.
- The legislation requires that an independent cover pool monitor be appointed which meets certain qualifications and which must provide reports in respect of the cover pool assets, including as to compliance with the statutory overcollateralisation requirements, compliance of the assets in the cover pool with the eligibility requirements under the legislation and the accuracy of the cover pool register.
- APRA's Prudential Standard requires issuing ADIs to have in place policies, procedures and systems to manage all exposures to their covered bond vehicles.

With approximately EUR 14 bn. in new EUR benchmark issuance in 2022, Australian and New Zealand issuers have returned to the market following a period of relative absence during the COVID-19 pandemic. Australian issuers have issued in EUR, USD and GBP, and, as such, their share of the overall global covered bond market across currencies has increased relative to prior years.

2022 was the first year since 2016 that all licensed issuers in the region have printed new EUR benchmarks in covered bonds. While EUR has remained the most active issuance currency in Australia, representing two-thirds of all new bonds in volume, USD and GBP issuances have seen strong demand as well as issuances in CHF and AUD. New Zealand remained focused on EUR issuance only.

In terms of overall market share, with close to EUR 45 bn. outstanding, the region has regressed from its previous high of around 3% in 2019 and is now closer to 2% of all EUR denominated covered bond benchmarks.

With the term funding facility (TFF) for Australia and the funding for lending (FLP) programme for New Zealand, issuers in both countries had access to liquidity at very competitive rates and saw a corresponding reduction in market issuance. Neither programme was available beyond the end of 2022. Therefore, covered bonds are a key component in ensuring well-diversified wholesale funding portfolios for Australian and New Zealand issuers and, as such, issuance is expected to increase moderately or at least remain stable over the next few years.

Australian and New Zealand issuers remain key participants in international covered bond markets, issuing in EUR, USD, GBP, AUD and other currencies across different tenors to maintain a globally diversified funding platform.

BOX 5 | NEW ZEALAND MARKET by Robert Gallimore, Australian Securitisation Forum and Thomas Cohrs, Helaba

NEW ZEALAND

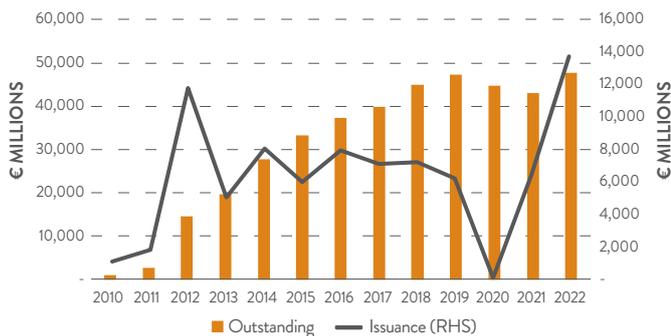
Covered bond programmes in New Zealand are similar to those of Australian issuers. Like Australia, covered bond holders in New Zealand have dual recourse against the issuer and, following certain trigger events, against the cover pool assets. As with Australian programmes, this second level of recourse is provided by the special purpose bankruptcy remote covered bond guarantor providing a guarantee for the benefit of covered bond holders, which is secured over the cover pool assets. In New Zealand, only residential mortgages are held by the covered bond guarantor.

The Reserve Bank of New Zealand (RBNZ) as the prudential supervisor of banks in New Zealand does not prescribe what assets can be sold to the covered bond guarantor. However, it does have the ability to register covered bond programmes under class designations based on the types of assets in the cover pool. In addition, the conditions of registration that apply to New Zealand issuers limit the amount of total assets that may be owned by the relevant covered bond guarantor to 10% of that bank issuer's total assets.

While banks in New Zealand were able to issue covered bonds without any changes in law, the Banking (Prudential Supervision) Act was amended in 2013 to provide covered bond holders with greater certainty that their security over cover pool assets would remain enforceable if the issuing bank failed. The Act requires the RBNZ to maintain a public register of covered bond programmes and specifies that banks in New Zealand may only issue covered bonds under registered covered bond programmes. Each bank's programme is reviewed by the RBNZ before it is registered. Similar to Australia, the Act also requires the appointment of an independent cover pool monitor to report on the accuracy of the coverage tests included in the relevant programme and cover pool register. The Banking (Prudential Supervision) Act does not provide for a minimum amount of overcollateralisation but does require that the value of the

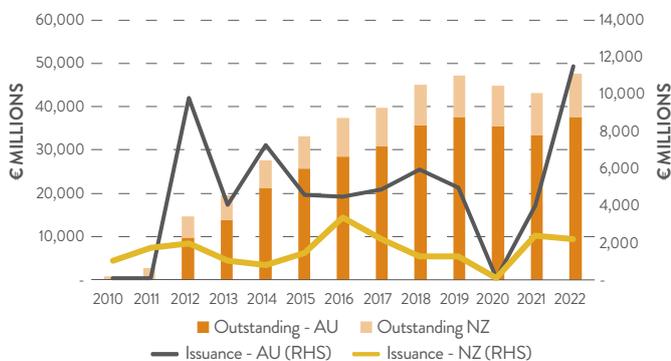
cover pool assets is at least equal to the principal amount of outstanding covered bonds. Covered bond programmes in New Zealand embed the overcollateralisation in the programme documents. Each covered bond programme in New Zealand provides for the overcollateralisation to be the greater of the contractually specified amount and such other amount required by the relevant rating agency to maintain the current ratings of the covered bonds.

FIGURE 7 | ANNUAL COVERED BONDS ISSUANCE AND OUTSTANDING - COMBINED AU & NZ ISSUERS



Source: BNP Paribas, Bloomberg, EMF-ECBC

FIGURE 8 | ANNUAL COVERED BONDS ISSUANCE AND OUTSTANDING - AU & NZ ISSUERS



Source: BNP Paribas, Bloomberg, EMF-ECBC

ASIA

Korea and Singapore pioneered covered bond issuance in developed Asia. As customer deposits primarily fund local banks, their main motivation in establishing covered bond programmes was to manage asset liability mismatch risk and diversify their funding sources.

Covered bonds in **South Korea** can be issued through the Covered Bond Act and the Korea Housing Finance Corporation Act. The Korean Housing Finance Corporation (KHFC) has issued covered bonds since 2010 and was joined by Kookmin Bank in 2015. Since then, KHFC issued the first social covered bond from Asia and the first Korean euro-denominated covered bond in 2018, and KEB Hana Bank established its own programme and inaugural euro-denominated issuance in January 2021. A few years ago the Korean Financial

Services Commission adopted several measures to encourage covered bond issuance, including reduced registration fees for issuance and lower capital requirements for investors. These measures incentivised the issuance of South Korean won-denominated bonds and, since 2019, five financial institutions, including KHFC, have issued covered bonds in the domestic market.

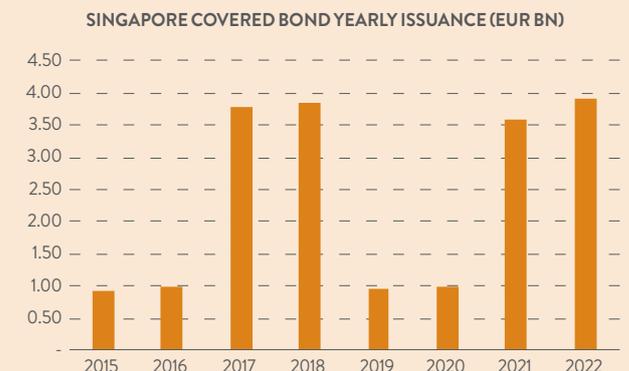
The regulatory framework for the issuance of covered bonds by banks incorporated in **Singapore** was established in 2013 and refined in 2015 through the Monetary Authority of Singapore (MAS)'s Notice 648. With the legislative framework in place, the three major domestic banks have already set up their programmes and issued, cumulatively, the equivalent of more than €14 bn as of mid-2022. The increased asset encumbrance limit to 10% from 4% of the issuer's total assets since October 2020 has provided more headroom for further issuance. However, overall supply will likely be limited because banks in Singapore are mostly funded by depositors and have limited foreign currency funding needs (see Box 6).

BOX 6 | SINGAPOREAN MARKET by **Colin YS Chen**, DBS Bank & Chairman of the ECBC Global Issues Working Group

SINGAPORE

Covered bonds as a funding tool for banks came into existence in Singapore after revisions to the final covered bond legislation, MAS Notice 648, were introduced in 2014. DBS Bank Ltd. performed the country's inaugural covered bond issuance. Since then, the nascent market has grown to include OCBC and UOB as issuers, and the local market cumulatively issued the equivalent of EUR 15 bn. as of 31 December 2021 and issued four covered bonds in 2021 equivalent to EUR 3.7 bn. (see Figure 9). As the market continues to grow, foreign banks incorporated in Singapore are also considering setting up covered bond programmes in the country to tap demand.

FIGURE 9 | COVERED BOND YEARLY ISSUANCE FROM SINGAPOREAN ISSUERS 2015-2021, EUR BN.



Source: EMF-ECBC, Bloomberg

Singaporean covered bonds rely on structural arrangements to provide security over the cover pool. The covered bond market is regulated by MAS Notice 648, which stipulates requirements on issuers (financial institutions incorporated in Singapore), cover pool assets (residential mortgages), asset encumbrance limit (10%) and overcollateralisation (3%), among other things.



So far, Singaporean banks have issued across a mix of currencies (EUR, GBP, AUD, USD) according to each issuing institution's funding requirements. This is expected to continue in response to banks' continued local and regional expansion. Singapore is fully supportive of the global harmonisation efforts, with all Singaporean issuers being ECBC Label holders and adhering to global best practices.

To the Future, and Beyond

The covered bond market in Singapore has been on an upward trajectory since the first issuance in 2015, with a slow-down in 2019. The future issuance pipeline is strong, with banks indicating their commitment to a regular presence in the market for benefits including market access maintenance, investor-base diversification and funding diversification. 2021 covered bond issuance levels have seen a return to the levels witnessed in 2017/2018.

Furthermore, market participants engage with each other and the regulator through the Association of Banks in Singapore's (ABS) Standing Committee on Covered Bonds. This committee represents the commitment from the industry and highlights the support from/collaboration with local authorities that will mark the next phase of growth for the Singaporean covered bond market.

Since there is no dedicated legal framework in **Japan**, when Sumitomo Mitsui Banking Corporation (SMBC) issued the first Japanese covered bond in November 2018, it based its programme on a contractual structure. Likewise, Sumitomo Mitsui Trust Bank (SMTB) launched its inaugural covered bonds in October 2020 with a structure like SMBC's. Given the availability of domestic deposits, it appears that the main reason for establishing covered bond programmes in Japan is to attract cheap foreign currency funding.

The Japanese covered bond market has considerable growth potential. Local lenders are already using collateralised lending, such as residential mortgage-backed securities (RMBS), and they have now started adding covered bonds to their funding mix. Outstanding mortgage loans stand at around ¥200 trillion, of which only 15-20% is currently used as RMBS collateral, leaving ample capacity for covered bond issuance. Japanese banks have considerable foreign currency-denominated assets and covered bonds could constitute a competitive source of funding for these assets. From a risk and regulatory perspective, covered bond issuance can reduce asset-liability duration mismatch.

We expect that issuance in developed Asia will be constrained by the availability of customer deposits, limited funding needs in foreign currencies and weak loan growth. Legislative and regulatory initiatives will likely stimulate further issuance. Developing Asia has greater growth potential, where it is anticipated that housing finance needs will grow substantially, but legislative developments will be essential.

Issuers in **China** have expressed increased interest in dual-recourse issuance in the past few years. Since larger banks in China benefit from abundant liquidity and strong deposit bases, the appetite for covered bonds mainly reflects increasing risk awareness – specifically, the importance of having alternative tools for banks to plan for rainy day funding, rather than current funding

needs. Aside from limited issuers' supply, several other legal and regulatory questions should be considered. The incumbent asset issue is a primary challenge for covered bond issuance. China has regulations on the protection of deposit holders, and the arrangement to ringfence specific banks' assets to benefit covered bondholders could be complicated without a dedicated legal framework. Moreover, legally, deposit holders enjoy a very high ranking in the allocation waterfall after banks' liquidation in the region. Because these assets' ringfencing and deposit ranking relate to the sovereign banking laws, regulators may find it difficult to have flexibility, even if they support the development of covered bond issuance. Finally, it is unclear whether an on-shore special-purpose vehicle could validly provide a guarantee for payments. So, while banks in China are likely to investigate covered bond options, it will probably take regulatory and deal-arranging efforts for issuance to materialize.

India has a significant shortage of affordable housing and a young and growing population. Moreover, household debt as a percentage of GDP is below that of other emerging markets. These factors suggest significant growth potential for the country's housing finance sector. Currently, customer deposits are Indian banks' primary source of funding, but issuers and regulators are considering alternative sources of wholesale funding, including covered bonds. For example, in 2019 the Reserve Bank of India (RBI) constituted a Committee on the Development of the Housing Finance Securitisation Market, which recommended, among other things, an enhanced role for the National Housing Bank and further amendments to reduce the securitisation transaction costs. Like other Commonwealth countries, such as Australia and the U.K., India does not have specific securitisation legislation. Rather, the legal framework for India's securitisation market is based on existing trust, contract and property law, and a series of RBI guidelines. If covered bonds are issued in India, they may at least initially be issued under a general-law framework with an appropriate supportive regulatory framework. In this context, key clarifications required will include whether issuance is permitted under Indian legislation generally, whether existing securitisation guidelines can be applied to covered bonds, how asset segregation can be achieved, the treatment of assets in an issuer insolvency, and whether any tax challenges would apply, including stamp duty and withholding tax.

AFRICA

Morocco was the first country in the continent to approve a covered bond legislation in 2022. However, it took almost a decade to move from the draft to the final legislation, which is a testament to the difficulties that can be encountered in the legislative process.

South Africa has historically ruled out covered bonds because of concerns about their seniority over depositors. In 2014-2015, these regulatory concerns seemed to diminish, thanks to a discussion regarding resolution regimes and, specifically, the anticipated introduction of retail depositor guarantees. However, domestic investors – who provide a considerable amount of domestic bank funding – remain resistant to the idea of a covered bond framework. This is due to their concerns about the potential pricing pressure on their senior unsecured debt, the losses if an issuer becomes insolvent and ratings implications for this debt. Hence, it is unlikely a covered bond market will develop in South Africa any time soon.

SECTION III. HARMONISATION AND GLOBAL BEST PRACTICES

Identifying Fundamental Principles of Covered Bonds

By **Sascha Kullig**, Verband Deutscher Pfandbriefbanken (vdp) and **Maureen Schuller**, ING Bank

Covered bonds are widely used around the globe, but their regulatory treatment varies. To achieve global convergence, the ECBC Global Issues Working Group (GIWG) aims to develop the fundamental principles of covered bonds on a global scale. A common understanding of such fundamental principles could also support countries that consider introducing a covered bond framework. With this purpose, the GIWG has in the past few years conducted different types of analyses, including on the preferential treatment of covered bonds around the globe as well as on the alignment of global regimes with the regulatory harmonisation process in Europe.

THE REGULATORY TREATMENT OF COVERED BONDS ON A GLOBAL SCALE – ON DIFFERENT TRACKS

As a reference for developing the fundamental principles of covered bonds on a global level, the GIWG first conducted an analysis of the requirements that covered bonds have to meet globally in order to receive preferential regulatory treatment. The focus was on preferential risk weightings for banks and insurance companies, the qualification as liquid assets according to the Liquidity Coverage Ratio (LCR), the treatment within the Net Stable Funding Requirements (NSFR) framework, the exemption from bail-in, exposure limits, investment limits and the eligibility for central bank liquidity.

The feedback received from the Eurozone, Canada, Denmark, South Korea, Sweden and Turkey revealed that covered bonds are recognised as liquid assets according to the LCR in all countries, albeit to a different extent. However, such consistent preferential treatment is the exception rather than the rule.

Overall, the preferential treatment of covered bonds for risk weight purposes or within the scope of the liquidity coverage and net stable funding ratio requirements still remains largely a European phenomenon. Outside Europe, the treatment of covered bonds is mostly aligned with the Basel Committee on Banking Supervision (BCBS)' stipulations, meaning that covered bonds are barely treated more favourably than senior unsecured instruments. Even the eligibility of covered bonds for central bank collateral purposes is not commonplace and typically restricted to national currencies.

Apart from that, the requirements for a preferential treatment of covered bonds are not always very detailed, which prompted the GIWG to conclude that the currently applicable requirements for a preferential treatment of covered bonds on a global level do not offer an appropriate starting point for the fundamental principles of covered bonds.

In Europe preferential treatment is now based on the Covered Bond Directive. Covered bonds issued as of 8 July 2022 will at minimum have to meet all

the mandatory requirements of this Directive to be eligible for a favourable treatment. In addition, covered bonds issued before that date have to meet certain requirements from the Directive on top of the UCITS 52(4) requirements. For instance, these include the investor information requirements and certain covered bond special supervision requirements. Elsewhere, in non-European countries, the relevant laws or regulations often merely require a 'dedicated' covered bond law without outlining more details or definitions.

Having said that, the recognition and protection of the secure nature of covered bonds seems to be spreading beyond Europe. For instance, the Canadian regulator explicitly decided to shield secured liabilities such as covered bonds from the bail-in tool applicable to domestic systemically important banks (D-SIBs) under the Canadian resolution regime effective since September 2018. Furthermore, the Basel III reforms announced at the end of 2017 call for a more favourable risk weight treatment for covered bonds, paving the way for a preferential treatment of covered bonds on a global scale.

The current state of play on the introduction of preferential risk weights for covered bonds at global level

BASEL III REFORMS PAVE THE WAY FOR PREFERENTIAL RISK WEIGHT TREATMENT AT A GLOBAL LEVEL

In December 2017 the BCBS finalised its post-crisis regulatory reforms, which provide for the preferential risk-weights for covered bonds at a global level. The Basel III reforms (often dubbed as Basel IV – see Box 7) should be implemented by 1 January 2023, after a one-year postponement due to the COVID-19 pandemic.

The requirements set by the BCBS are founded on the more general conditions according to Article 52 (4) of the UCITS-Directive and similar to the additional requirements according to the old Article 129 of the CRR.



BOX 7 | The Basel III reforms' impact on covered bonds**Definition of Covered Bonds**

Covered bonds are defined as bonds issued by a bank or mortgage institution subject by law to special public supervision designed to protect bondholders. In line with the law, bond proceeds must be used to finance assets capable of covering the claims attached to the bonds during their term. In the event of a failure of the issuer these proceeds would be used on a priority basis for the (re)payment of the principal and accrued interest.

Asset Eligibility

The eligible cover assets are restricted to:

- Claims on/guaranteed by, sovereigns, their central banks, public sector entities or multilateral development banks.
- Claims secured by residential real estate with an LTV of 80% or lower that meet the applicable requirements on, for example, legal enforceability, the claim of the bank over the property and the ability of the borrower to pay.
- Claims secured by commercial real estate with an LTV of 60% and lower that meets the applicable requirements.

- Claims on banks that qualify for a 30% or lower risk weight up to 15% of outstanding covered bonds.

Additional collateral may also include substitution assets and derivatives entered into for the purpose of hedging risks related to the covered bond programme.

Overcollateralisation

The nominal overcollateralisation should be at least 10%. Where national legislations do not provide for a 10% minimum overcollateralisation, the issuing bank should regularly disclose that the 10% requirement is met in practice.

Disclosure requirements

For covered bonds to be eligible for preferential treatment, the banks investing in the covered bonds should be able to demonstrate that it receives (at least semi-annually) portfolio information on at least:

- The value of the cover pool and the outstanding covered bonds.
- The geographical distribution and type of cover assets, loan size, interest rate and currency risks.
- The maturity structure of the cover assets and covered bonds.
- The percentage of loans more than 90 days past due.

On the back of the Basel III reforms several countries outside Europe intend to provide for a preferential risk weight treatment of covered bonds. Singapore and South Korea plan to fully implement the BCBS requirements for such preferential treatment. Similarly, Australia aims to introduce favourable risk weights, but only for rated covered bonds. In Canada, the Office of the Superintendent of Financial Institutions (OSFI) does adopt the asset eligibil-

ity and disclosure requirements for covered bonds of the Basel reforms, but with a minimum overcollateralisation requirement of 5%. Nonetheless, covered bonds will only receive a similar risk weight treatment as similarly rated (unsecured) bank exposures. Elsewhere, in New Zealand, the banking prudential requirements of June 2021 do not make reference to separate risk weights for covered bonds.

FIGURE 10 | RISK WEIGHT TREATMENT FOR EXPOSURES TO RATED COVERED BONDS

External rating	AAA to AA-	A+ to A-	BBB+ to BBB-	BB+ to B-	Below B-
Basel III (reformed)	10%	20%	20%	50%	100%
Basel III (current)	20%	50%	50%	100%	150%
CRR (current)	10%	20%	20%	50%	100%

Source: Basel Committee on Banking Supervision, European Commission

FIGURE 11 | RISK WEIGHT TREATMENT FOR EXPOSURES TO UNRATED COVERED BONDS

Risk weight issuing bank	20%	30%	40%	50%	75%	100%	150%
Basel III (reformed)	10%	15%	20%	25%	35%	50%	100%
CRR (current)	10%	—	—	20%	—	50%	100%

Source: Basel Committee on Banking Supervision, European Commission

THE STATUS ON THIRD COUNTRY EQUIVALENCE WITHIN THE EU

In Europe the equivalent treatment of covered bonds issued by non-EEA credit institutions was left outside the scope of the Covered Bond Directive and the amendments to Article 129 of the CRR. Instead, the European Commission will submit a report on third country equivalence to the European

Parliament and Council by 8 July 2024 at the latest. This report may be accompanied by a legislative proposal on whether or how an equivalence regime should be introduced. In this context, it is important to bear in mind however, that as of 8 July 2022 the amended CRR no longer refers

to the UCITS 52(4) requirements as one of the conditions for preferential risk weight treatment. Only for covered bonds issued before 8 July 2022 most old CRR requirements, including the UCITS 52(4) reference, may still be applicable under the transitional measures. Instead, as of 8 July 2022 the new definition for covered bonds per Article 3(1) of the Covered Bond Directive becomes determinant for preferential risk weight treatment. Unlike UCITS 52(4), Article 3(1) of the Covered Bond Directive does not make reference to the fact that covered bonds have to be issued by a credit institution with a registered office in an EEA Member State.

However, without third country equivalence provisions, this would still imply that to benefit from a preferential treatment, third country covered bonds would: a) have to meet all the mandatory requirements of the Covered Bond Directive as per Article 3(1) of this Directive; plus b) the further requirements of the amended CRR with reference to the monitoring of property values, minimum 5% overcollateralisation and eligible substitution assets. In a Q&A document, on 17 December 2021 the European Banking Authority (EBA) confirmed that as long as an equivalence regime has not been introduced, covered bonds that do not meet the criteria and requirements for eligible covered bonds according to the amended Article 129(3), (3a) and (3b) CRR, in conjunction with Article 3 of the Covered Bond Directive, should not use the favourable 11.25% Loss Given Default (LGD) for covered bonds under the internal rating based approach (Article 161 CRR), but the 45% LGD for senior exposures instead.

The next section provides some insights on the alignment of global covered bond regimes with the European Covered Bond Directive, building upon the work of the ECBC Global Issues Working Group.

GLOBAL BEST PRACTICES – TO WHAT EXTENT ARE GLOBAL REGIMES ALIGNED WITH THE EU DIRECTIVE AND ART. 129 CRR?

As explained at the end of the Note, for an equivalence assessment the fundamental covered bond principles that have to be fulfilled should be determined in a first step. Without prejudging the deciding parties, these could be the following aspects based on the EU Covered Bond Directive:

dual recourse, bankruptcy remoteness of covered bonds, asset segregation, eligible cover assets, investor information, coverage requirement, covered bond public supervision and reporting to the competent authorities.

Over the past few years, on several separate occasions the ECBC Global Issues Working Group analysed how different global covered bond regimes met – at that time – the *proposals for covered bond harmonisation* in the EU. The first analysis aimed to identify to what extent the different global covered bond regimes met the *proposals for covered bond harmonisation* in the EU, disclosed by the EBA in December 2016.

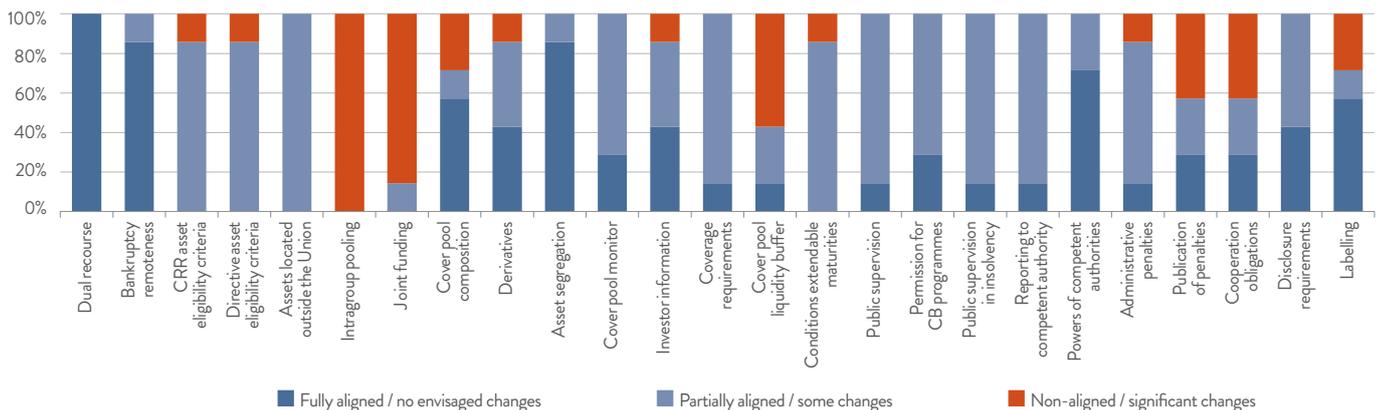
In 2020, the ECBC provided an update based upon the proposed EU Covered Bond Directive and the amendments to Article 129 of the CRR in Europe as published in the Official Journal of the European Union on 18 December 2019.

This analysis revealed that most global covered bond regimes were already fairly strongly aligned with the principles-based EU Covered Bond Directive and would, in most cases, probably not require significant amendments to become fully aligned. This is an important observation in light of any future EU third country equivalence assessment. The following remarks refer to the time of the analysis back in 2020.

Importantly, there is full alignment with the Directive’s dual recourse requirements and an almost full alignment with the bankruptcy remoteness and asset segregation requirements. On the other hand, virtually none of the global regimes provide for intragroup or joint funding options. The non-alignment in this field is not particularly relevant, especially since, for example, the intragroup covered bond funding is just an option for national legislators. Hence, there is no obligation to implement it.

Global covered bonds are, for obvious reasons, typically secured by assets located outside the European Union. The Directive allows for inclusion of these assets in cover pools if these assets meet the Directive’s eligibility criteria and realisation of the assets is legally enforceable in a similar way to assets located in the EU. Most global covered bond regimes have established asset eligibility criteria and, as such, partially meet the Directive’s requirements. For example, residential mortgage loans would generally be eligible up to the soft LTV limit of 80% specified in the amended Article 129 CRR. However,

FIGURE 12 | ECBC GIWG - DIRECTIVE ALIGNMENT PER REQUIREMENT (AS OF 2020)



Source: EMF-ECBC

not all covered bond frameworks explicitly provide for credit quality restrictions on exposures to institutions or third country public sector exposures, or provide for the required legal certainty or property valuation in line with the language of the CRR.

Global covered bond regimes do provide for nominal coverage, but are not always as detailed as the Directive with reference to the type of cover assets that should contribute to the coverage requirement, i.e. being the primary assets, substitution assets, assets held for liquidity buffer purposes or payment claims related to derivative contracts. Moreover, several jurisdictions lack the requirement to take into account the expected costs related to the winding-down of the covered bond programme.

The minimum required nominal overcollateralisation level of 5% as specified in the amended Article 129 CRR, is only met by one country on the level of the legal framework (statutory). This is often met on an issuer-by-issuer basis on a contractual level. When the voluntary overcollateralisation is considered too, all jurisdictions would meet this requirement. According to the Article 129 CRR, a lower overcollateralisation requirement of at least 2% may also be applied if the calculation of the overcollateralisation is either based upon a formal approach that takes into account the underlying risk of the assets, or on a formal approach where the valuation of the assets is subject to the mortgage lending value.

Most global covered bond jurisdictions do not explicitly provide for a 180 days liquidity rule, even though other types of liquidity provisioning can often be found in global frameworks. While commonly allowed, the use of extendable maturity structures is also not necessarily defined by law. That said, while global legal frameworks lack objective extension triggers, maturity extension triggers are, where applicable, mostly specified in detail in the contractual terms and conditions.

Global covered bond regimes are subject to covered bond public supervision, but would not explicitly require, by law, that competent authorities should have the expertise, resources, operational capacity, powers and independence necessary to carry out the function of covered bond public supervision. Global covered bond regimes require permission from the competent authority to issue covered bonds, but some countries lack detailed requirements for permission. Provisions for supervision in insolvency or resolution are also often not as detailed as stipulated in the Directive, while there are notable differences between the global frameworks on the reporting requirements to the competent authorities. Not all global covered bond regimes fulfil the requirements for an independent covered bond monitor. But since this feature doesn't have to be implemented by EU Member States, this should not be regarded as a misalignment with the EU Directive.

Some time has now passed since this analysis was conducted and it is quite possible that some third countries have already made adjustments to their covered bond regulations. The country reports in the ECBC Fact Book 2022

provide a good overview and, in addition, the ECBC's covered bond comparative database is particularly recommended. This is a unique tool to compare key features of each covered bond jurisdiction, access links to issuer's cover pool information and access national covered bond legislation (in English). The database can be accessed at <https://compare.coveredbondlabel.com/>.

Furthermore, it is also worth highlighting that many issuers from third countries use the ECBC Covered Bond Label. The Label covers the most relevant fundamental covered bond principles, such as dual recourse, asset eligibility criteria, coverage requirements and supervision of the covered bond issuer. This confirms the strong overlap between the core principles of the European Covered Bond Directive and market practices around the globe.

FIGURE 13 | THE COVERED BOND LABEL CONVENTION CRITERIA

I. Legislation Safeguards

- a) The covered bond programme is embedded in a dedicated national covered bond legislation.
- b) The bond is issued by - or bondholders otherwise have full recourse, direct or indirect, to - a credit institution which is subject to public regulation and supervision.
- c) The obligations of the credit institution in respect of the cover pool are supervised by public supervisory authorities.

II. Security Features Intrinsic to the Covered Bond Product

- a) Bondholders have a dual claim against:
 - i. The issuing credit institution as referred to in point I b).
 - ii. A cover pool of financial assets (mortgage, public sector or ship assets), ranking senior to the unsecured creditors.
- b) The credit institution has the ongoing obligation to maintain sufficient assets in the cover pool to satisfy the claims of covered bond holders at all times.
- c) Issuers are committed to providing regular information enabling investors to analyse the cover pool, following the Harmonised Transparency Template (HTT) and in compliance with the transparency requirements of Article 129(7) of the CRR.

Source: ECBC, Covered Bond Label

THE IMPACT OF THE EU COVERED BOND DIRECTIVE ON THE LCR TREATMENT OF THIRD COUNTRY COVERED BONDS

Third country covered bonds are eligible as level 2a high quality liquid assets under the EU LCR Delegated Regulation if they meet the applicable requirements. The European Commission delegated regulation of 10 February 2022, amending the LCR delegated regulation, aligns the European LCR regulation with the amended Article 129 of the CRR and the Covered Bond Directive. The amendments applied as of 8 July 2022 and impacted third country covered bonds as follows:

* These entail minimum portfolio information on the value of the cover pool and the covered bonds outstanding, a list of the ISINs of all covered bonds issued under the programme (if one has been attributed), the geographical distribution and type of cover assets, their loan size and valuation method, details in relation to market risks (interest rate and currency) and credit and liquidity risks, the maturity structure of the cover assets and covered bonds plus an overview of the applicable maturity extension triggers, the levels of required and available coverage, and of statutory, contractual and voluntary overcollateralisation, and the percentage of loans where a default is considered to have occurred pursuant to Article 178 CRR, and in any case where the loans are more than 90 days past due.

- The (semi-annual) transparency requirements of Article 129(7) CRR were replaced with the more detailed (quarterly) investor information requirements of Article 14 of the Covered Bond Directive.*
- The requirements of the Covered Bond Directive in Articles 6(2), 6(3)(a) and Article 6(5) on the credit institution's claim for payment and on the valuation of physical collateral assets should be met where the pool comprises loans secured by immovable properties. These replaced the previous Article 208 and Article 229(1) CRR valuation requirements.
- The asset eligibility criteria for third country covered bonds remained virtually the same as they already excluded securitisation notes as eligible assets, but the Article 129(1)(c) CRR minimum rating requirements for exposures to credit institutions became more lenient.

The LCR amendment proposals did not further discuss the required equivalence of the supervisory and regulatory arrangements of third countries to those applied in the EU. This being said, it is anticipated that the mandatory special supervision requirements from the Covered Bond Directive will probably be seen as the reference for the equivalence assessment of third country supervisory and regulatory arrangements as of 8 July 2022.

BOX 8 | The EU LCR requirements for third country covered bonds

Exposures in the form of covered bonds issued by credit institutions in third countries which comply with the following requirements:

- i) They are covered bonds in accordance with the national law, which defines them as debt securities issued by credit institutions or by a wholly owned subsidiary of a credit institution which guarantees the issue and secured by a cover pool of assets in respect of which bondholders have a direct recourse for the repayment of principal and interest on a priority basis in the event of issuer default.
- ii) The issuer and the covered bonds are subject by national law to special public supervision to protect the bondholders and the supervisory and regulatory arrangements applied in the third country must be at least equivalent to those applied in the European Union.
- iii) The covered bonds are backed by a pool of assets of one or more of the types described in Article 129(1) CRR, points (b), (d), (f) and (g):

- Credit Quality Step (CQS) 1 third country public sector exposures or CQS 2 third country public sector exposures subject to a 20% cap versus the outstanding covered bonds
- Residential property loans up to 80% of the value of the pledged properties
- Commercial property loans up to 60% of the value of the pledged properties (70% if the OC exceeds 10%)
- Ship loans up to 60% of the value of the pledged ship

Where the pool comprises loans secured by immovable properties, the requirements set out in Article 6(2), Article 6(3)(a) and in Article 6(5) of the Covered Bond Directive must be met regarding the claim for payment of the credit institution and on property valuation.

- iv) Exposures to institutions in the cover pool meet the Article 129(1) (c) and Article 129(1a) CRR requirements.
- v) The credit institution investing in covered bonds and the issuer meet the transparency requirements of Article 14 of the Covered Bond Directive.
- vi) The bonds are at least CQS 1 (AA- or better) rated, have an equivalent short-term rating, or if non-rated have a 10% risk weight.
- vii) The cover pool meets at all-times an asset coverage requirement of at least 7%, or 2% for covered bonds with a minimum €500 mn. issue size (or the equivalent amount in domestic currency).

IN SUMMARY

The overall conclusion is that the fundamental covered bond principles, laid down in the European Covered Bond Directive and Article 129 CRR already represent global best practice to a large extent. In particular, this applies to the following aspects: dual recourse, bankruptcy remoteness, asset segregation, asset eligibility criteria (incl. LTV), minimum coverage requirements and special supervision (incl. asset monitor). These are criteria that are also broadly covered by the qualitative standards for covered bonds under the Covered Bond Label Convention. However, it remains to be seen how detailed the specifications of the fundamental principles will be in an equivalence assessment, since the level of technical details could be the second dimension of an equivalence test (as explained in the following article).

SECTION IV. THE EQUIVALENCE ASSESSMENT PROCEDURE OF THE EUROPEAN COMMISSION AT A GLANCE

By **Wolfgang Kälberer**, EMF-ECBC Strategic Adviser

ARTICLE 31(1) COVERED BOND DIRECTIVE

Article 31(1) defines the pathway for the European Commission to approach the equivalence assessment of third countries' covered bond regimes. This states:

“By 8 July 2024, the Commission shall, in close cooperation with EBA, submit a report to the European Parliament and to the Council, together with a legislative proposal, if appropriate, on whether and, if so, how an equivalence regime could be introduced for third country credit institutions issuing covered bonds and for investors in those covered bonds, taking into consideration international developments in the area of covered bonds, in particular the development of legislative frameworks in third countries.”

Before taking a closer look at this paragraph, it is useful to collect available information dealing with equivalence assessments at EU level. Indeed, there are two documents providing some insight into the equivalence procedure of the EU Commission:

- Commission Staff Working Document of 2017: *EU equivalence decisions in EU financial services policy: an assessment*
https://finance.ec.europa.eu/eu-and-world/equivalence-non-eu-financial-frameworks_en
- Communication from the Commission of 2019: *Equivalence in the area of financial services*
https://finance.ec.europa.eu/publications/commission-sets-out-its-equivalence-policy-non-eu-countries-and-presents-its-recent-eu-equivalence_en

MAIN FEATURES OF THE EU EQUIVALENCE ASSESSMENT PROCEDURE

Both documents make clear that the equivalence decision is a unilateral and discretionary act of the EU Commission, both for its adoption and any possible amendment or repeal. Typically, a Commission equivalence decision takes the form of an Implementing Act (Level II Delegated Act) which can be adopted only after confirmation by representatives appointed by the Member States in a vote of the Regulatory Committee. The Commission's assessments of equivalence are usually based on technical advice from European supervisory agencies (EBA, European Securities and Markets Authority – ESMA or European Insurance and Occupational Pensions Authority – EIOPA).

The equivalence decision requires the corresponding empowerment by the basic legal act which sets out the conditions, criteria and extent to which the EU may take into account the regulatory and supervisory framework of a third country. As regards the assessment process itself, proportionality and risk

management as regards the cross-border activity underpinned by equivalence are the two guiding principles for the assessment process.

Beyond the technical assessment of the equivalent legal framework on the basis of the identified fundamental principles of covered bonds embedded in effective supervision and enforcement by third country authorities (see Section III above), a number of more general financial policy criteria are taken into consideration by the European Commission. More precisely, these aspects could consist of:

- risk to reputation and long-term stability of the EU financial sector;
- compatibility with EU policy priorities and international standards;
- requirement for corresponding recognition/equivalence possibilities in a third country (reciprocity and/or supervisory cooperation arrangements);
- principle of proportionality (high impact vs. low impact third countries); and
- good tax governance, anti-money laundering and terrorist financing considerations.

Hence, the Commission may look on a case-by-case basis, beyond the specific technical solutions envisaged and focus on the regulatory objectives pursued and the outcomes delivered by that framework, particularly regarding the impact of the third country regime on EU markets. In this context, factors such as the size of the relevant market, the importance for the functioning of the internal market, the interconnectedness between the markets of the third country and the EU, or the risks of circumvention of EU rules may play a role. The Commission also factors in wider external policy priorities and concerns, in particular with respect to the promotion of common values and shared regulatory objectives at international level.

Finally, the monitoring and enforcement of third countries' on-going compliance with the equivalence criteria set out in the relevant EU legislation are also taken into consideration. This is complemented by the European Supervisory Authorities engaging and taking the lead in specific monitoring tasks (following regulatory developments in the third country and its supervisory record, cooperation between supervisors in the EU and in the third country). Equivalence decisions can be reviewed at any time and may result in the Commission unilaterally withdrawing equivalence.

From the outset, the whole process typically involves an intensive technical dialogue with the competent authorities of the third country. Third country authorities are invited to contribute to fact-finding exercises relating to the way in which their regulatory and supervisory frameworks deliver the outcomes as set out in the corresponding EU framework.

ASSESSMENT OF ARTICLE 31(1) COVERED BOND DIRECTIVE

To confirm the findings in Section III above, this Article neither contains an empowerment for the EU Commission to take an equivalence decision (implementing act) nor does it define tangible technical requirements or criteria applicable to the equivalence assessment itself. Article 31(1) only requires the EU Commission/EBA to submit a report on the ‘whether’ and ‘how’ an equivalence regime could be introduced. This report can be combined with a legislative proposal, but the Commission might consider that such a proposal is not (yet) appropriate. The submission of the report is mandatory, the legislative proposal is not.

Therefore, a “three steps” approach seems to apply: a report would justify the introduction of an equivalence regime for third countries in the EU and define the underlying requirements. A legislative proposal (Directive or Regulation) would then transpose these requirements into a legal act and provide the empowerment for the EU Commission to take an implementing decision. And finally, the Commission would recognise the equivalence after thorough assessment of the third country’s covered bond framework.

Ideally, the European Commission would table both the report and a legislative proposal in July 2024. The latter must be adopted through an ordinary legislative procedure, the duration of which is difficult to predict. There will be European Parliament elections in May 2024 combined with a new Commission taking office on 1 November 2024. This might trigger a delay in the process.

In terms of content, Article 31(1) of the Covered Bond Directive provides only little guidance. Relevant aspects are the investors’ perspective and international developments in the area of covered bonds (developments of legislative frameworks in third countries). This is also where the Basel III rules on the supervisory regime of covered bonds can be taken into account.

To conclude, almost all technical requirements guiding the equivalence assessment are at the full discretion of the European Commission (assisted by the EBA). As regards timing, a Commission implementing decision on equivalence recognition will probably not be available during 2024 but rather at a later stage.

THE POTENTIAL COMPONENTS OF THE EQUIVALENCE ASSESSMENT EMBEDDED IN A LEGISLATIVE PROPOSAL

Whereas Box 8 represents a comprehensive best practice compilation of structural requirements from a product harmonisation perspective, the European Commission’s report and legislative proposal – for equivalence recognition purposes – might concentrate more on those aspects which were classified by EBA in 2016 as ‘step 1’ criteria (see Section III of this Note), combined with a strong focus on public supervision by domestic competent authorities. Reliance on the third country supervisor appears fundamental here. Both components will certainly be complemented by a compliance analysis with general financial policy targets of the EU.

Consequently, two dimensions appear intrinsic to the equivalence assessment: first, the extent of fundamental covered bond principles which shall be considered equivalence-relevant; and second, the level of technical detail as there is evidence that the more prescriptive equivalence requirements are drafted in terms of technical features, the higher the impact on equivalence recognition of third countries’ covered bond regimes.

Inspired by the UCITS Directive (former Article 52 IV) and by the EBA harmonisation principles of December 2016, the following aspects could be addressed by the legislative proposal of the European Commission: 1) issuance by a credit institution; 2) existence of a legal basis; 3) dual recourse; 4) asset segregation (bankruptcy remoteness); 5) eligible cover assets (quality requirements in terms of asset types, derivatives, LTV ratios, valuation); 6) coverage requirements (OC); 7) special public supervision; 8) liquidity rules; and 9) transparency (reporting & disclosures).

As regards the extent of technical specifications, there are good arguments for pursuing a principles-based approach. There will be a challenge in striking the right balance between the safety features of product components and the necessary flexibility for third countries and their market traditions. As an example, the requirement to issue covered bonds on the basis of a law doesn’t exclude the use of statutory rules for a wider range of technical provisions, but when it comes to bankruptcy rules such as asset segregation or priority claims against the cover pool, they should be enshrined in law in order to provide legal certainty against potentially competing or even contradictory general bankruptcy law in place (*lex specialis* takes precedence over *lex generalis*). Statutory rules cannot take precedence over law-based rules.

Similar challenges exist regarding the definition of eligible cover assets and quality requirements. Recognition of equivalence might not necessarily require a restriction of eligible cover assets to mortgages, ships and/or exposures to the public sector. But the dual recourse element shall secure a stand-alone economic value of cover pools in favour of covered bond creditors in case of default of the issuing institution, ensuring that foreclosure or recovery measures of collateral/securities enable full reimbursement of the principal and interest. The collateral would be required to have an intrinsic value on its own.

Each of the nine fundamental principles referenced above should be scrutinised accordingly.

Finally, it is to be expected that the legislative proposal to be submitted by the European Commission will also address general financial policy issues such as the potential impact of the third country covered bond regime under scrutiny on EU financial stability, market integrity, investor protection and the level-playing field in the internal market. At the same time, the benefits resulting from an equivalence recognition for the preservation of an open and globally integrated EU financial market combined with better market access will obviously also be relevant. Sections I and II provide the necessary data.

ECBC GLOBAL CONCEPT NOTE ON
THIRD COUNTRY EQUIVALENCE FOR COVERED BONDS

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EUROPEAN COVERED BOND COUNCIL