INDIAN SECURITISATION FOUNDATION

Proposal for legislative or regulatory changes in India for introducing covered bonds

This Note contains the proposal on the part of the Indian Securitisation Foundation about legislative or regulatory pronouncements/ changes required for introducing covered bonds in India

Executive Summary

- The case for introduction of covered bonds is well made in India, and has already been recognized by the NHB Working Group. Covered bonds will provide an alternative debt instrument for the bond markets; and will go a long way in promoting affordable housing finance, which complements the Govt's policy on Housing for All.
- Changes in legislation are NOT *necessary*, but will be *helpful*. The Ananta Barua Working Group has already noted that even in absence of any legislative changes, covered bonds may be introduced in India. However, the fact that covered bonds have not so far made a debut, the market will get a positive vibe if there is a regulatory move towards it.
- EU jurisdictions which have had covered bonds over decades in the past are now proposing to move towards a unified covered bond framework. Therefore, this is the right time for India to have a clear policy document on covered bonds.
- We suggest that for the interim, a regulatory statement stating principles of ring fencing may serve as an important reference point for practitioners.
- In terms of legislative changes, we recommend a small change via the Insolvency and Bankruptcy Code/similar law for bankruptcy of financial institutions, listing out priorities in the event of bankruptcy, to say that any special priorities (or subordination) as provided in the terms of issue of a capital market transaction, will prevail in winding up as well.

About Indian Securitisation Forum (ISF):

ISF is a not-for-profit entity representing the securitisation industry in India. The membership of the Foundation includes banks, NBFCs, microfinance institutions, other issuers and investors and securitisation professionals for promoting interest of securitisation and fixed income securities in India.

Typical investors in securitisation include public sector banks, private sector banks, mutual funds, insurance companies and others. Currently Foreign Institutional Investors (FIIs) have not been permitted to make investments in asset backed securities in India under the extant SEBI (Foreign Institutional Investors), Regulations, 1995. However, FIIs can invest in security receipts issued by asset reconstruction companies. While, it may not be incorrect to say what ABS is to securitisation of standard assets, security receipts (SRs) are to non-performing assets, the rationale for not permitting FIIs to invest in ABS yet permit them to invest in SRs in not known.

Similarly under the Foreign Exchange Management (Transfer or issue of security by a person resident outside India) Regulations, 2000 investment in SRs issued by asset reconstruction companies is permitted but ABS is not permitted.

As ISF is dedicated to the cause of promoting securitisation in India, we humbly submit our representation herein below on permitting FIIs to invest in securitised instruments.

About Covered Bonds

Covered bonds have been largely a European phenomenon till the sub-prime crisis in 2007[1]. Post the crisis when securitization had fallen out of favor, covered bonds came to the fore as an alternative financial instrument; an alternate to securitization, as covered bonds had a proven record of displaying resilience to the stressed market conditions.

Covered bonds, a hybrid between asset-backed securities/ mortgage backed securities and normal secured corporate bonds, are an instrument of refinancing, primarily used by mortgage lenders. Unlike secured corporate bonds which provide recourse against the issuer, covered bonds provide a bankruptcy-protected recourse against the assets of the issuer (Collateral Pool) too. Unlike mortgage backed securities which merely provide recourse against the Collateral Pool only, covered bonds provide an additional recourse against the issuer too.

Covered bonds have existed in Europe for over 200 years. However, in non-traditional jurisdictions, covered bonds made a debut recently. Some of the significant non-traditional countries where covered bonds have been issued include the following:

Country Name	**Year of Issuance(s) as structured covered bonds**	**Remarks, if any**
Canada	First issuances happened in 2016	Currently there is no legislation governing covered bonds in Canada
Germany	2013	This is an issuance outside the Pfandbriefe Act on Covered Bonds otherwise applicable to covered bonds issuances in Germany
France	2006	This is an issuance outside the legislation on Covered Bonds otherwise applicable to covered bonds issuances in France

[1] Covered bonds have been in existence for more than 200 years in several European countries.

Korea	2009	This issuance was under the Korea's covered bond programme 2009. Later Korea came out with the Korea Covered Bond Act, 2014.
New Zealand	2011	This issuance was prior to New Zealand enacting the Reserve Bank of New Zealand Covered Bond Amendment Act 2014.
Netherland	2015	This issuance was outside the Financial Supervision Act, 2008 as amended from time to time.
Singapore	2015	There is no legislation specific to covered bonds in Singapore.

Legislative framework for covered bonds:

Several countries have taken steps to put in place either legislation or enabling regulatory statements on covered bonds, while other countries have undertaken structured covered bonds bypassing the need for a regulation to precede the issuance. The legislative frameworks or regulatory guidelines in different countries have been depicted in Annexure - 1.

Therefore, countries, based on their legal structures, have three options for enabling covered bonds:

- Enact a specific law that deals with covered bonds, providing for bankruptcy ring-fencing (Legislation option)
- Rely on a regulatory pronouncement, particularly from a banking regulator, affirming that the assets of a cover pool will be first used for the payment to covered bondholders (Regulatory pronouncement option)
- Do nothing, and rely on the flexibility of its common law (Common law option).

Several of the EU countries have opted for the Legislation Option.

In September 2015, the European Commission circulated a consultative proposal for a harmonized legal framework in member countries for covered bonds[2]. The Consultation Paper was inspired by a July 2014 study, by the EBA, of legislative and capital requirements framework on covered bonds in the EU.[3]

The Consultation Paper notes that there is no generally-accepted definition of covered bonds currently, and the most commonly cited definition is that in Para 52 (4) of the UCITs Directive. The most important one among the 3 features as contained in the UCITs Directive is this: "sums deriving from the issue of the covered bonds must be invested in accordance with the law in assets which, during the whole period of validity of the bonds, must be capable of covering claims attaching to the bonds and which, in the event of failure of the issuer would be used on

[2] http://ec.europa.eu/finance/consultations/2015/covered-bonds/docs/consultation-document_en.pdf

[3] https://www.eba.europa.eu/documents/10180/534414/EBA+Report+on+EU+Covered+Bond+Frameworks+and+Capital+Treatment.pdf

a priority basis for the reimbursement of the principal and payment of accrued interest." Hence, the key condition is the availability of the assets in the cover pool to cover the claims on account of interest and principal on the bonds, on a priority basis.

In view of the fragmented and disparate nature of covered bonds laws in different member countries, the Consultation Paper proposes a "convergence of national laws towards a truly integrated and comprehensive covered bond framework, thus capable of delivering a recognisable "European covered bond instrument".

As a part of the legislative proposal, the Consultation Paper proposed a framework of an EU law on covered bonds consisting of the following items:

I. Covered bond definition and protection of the term;
II. Covered bond issuers and system of public supervision:
    a. issuer models and licensing requirements;
    b. on-going supervision and cover pool monitoring (pre-insolvency);
    c. covered bonds and the single supervisory mechanism (SSM).
III. Dual recourse and insolvency/resolution regime:
    a. definition of dual recourse principle;
    b. segregation of the cover assets;
    c. administration and supervision of the cover pool post-insolvency;
    d. interaction between cover pool and issuer in insolvency/resolution;
IV. The cover pool:
    a. eligible assets: qualifying criteria and requirements;
    b. coverage requirement and overcollateralisation;
    c. cover/assets liabilities risk mitigation: market and liquidity risks;
V. Transparency requirements.

The Consultation Paper also sought views on whether the SPV model should be recommended as the general basis for ring-fencing of assets. See a model of the covered bonds framework as proposed by the consultative paper in Annexure - 2.

Covered bonds in India

In India, a Working Group was set up under the Chairmanship of Shri Ananta Barua to evaluate prospects of promoting RMBS and other alternative capital market instruments – Covered Bonds. The Working Group submitted its Report and Recommendations[4] on October, 2012.

The Committee made recommendations on introduction of covered bonds into India both through the legislative route and also through the structured covered bonds route relying on the common law flexibility.

While evaluating the introduction of covered bonds under the exiting framework, the Working Committee report mentioned the following –

> *One of the threshold questions to examine is, if Indian issuers were to come up with covered bonds issuance under existing law, without intermediation of NHB or any other special agency, would they be able to attain any rating upliftment. It is notable that even though NHB has had, in case of RMBS transactions, an enabling platform for RMBS transactions, several issuers have issued private-label RMBS transactions. The*

[4] http://www.nhb.org.in/Whats_new/NHB%20Covered%20Bond%20Report.pdf

objective may be to retain flexibility that any standard platform or legislation would obviously curtail.

The Report examined structures with segregation of the assets and sale of the cover pool to an SPV and structures with segregation of the assets while comparing it with common law jurisdictions. The Report clearly mentioned the following –

> *".....So, the answer to the question – can we have covered bonds in India under the existing legal structure, without any special legislation – would be yes."*

Therefore, it is established by the Working Committee Report of NHB that covered bonds can be issued in India without any specific legislation. Proposed covered bonds structure using common law provisions is explained in Annexure - 3.

Proposed Covered Bonds regulatory or legislative structure:

Considering that India could use the common law flexibility to issue covered bonds, there is, as noted by Ananta Barua Group, no need for a specific law as such for covered bonds. However, in practice, the lack of law or lack of clarity in any regulatory pronouncement is appearing as a practical hurdle.

We are aware that several practitioners in reality have tried to speak to rating agencies/ law firms about introducing covered bonds in India. However, lack of clarity becomes a stumbling block.

It is notable that the rating enhancement in case of covered bonds hinges largely on the strength of the legal structured of the covered bonds. That is to say, unless covered bonds provide a bankruptcy-protected right over the collateral pool, the dual recourse nature ends up being a recourse only against the issuer, and therefore, covered bonds attain parity with secured corporate bonds.

The Report of the European Banking Authority (EBA) on EU Covered Bond Framework and Capital Treatment[5], that spoke about uniform covered bonds legislation in the EU also emphasized on the need for segregation of cover assets as reproduced below:

> *The segregation of the cover assets is a necessary component of the dual recourse mechanism, in that only by an effective segregation of the cover assets the priority claim of the covered bond investor on the cover pool can be ensured in the event of issuer default or resolution.....*
>
> *The identification and effective segregation of all the assets over which the investor has a priority claim should be ensured, depending on the issuer model adopted at the national level, either by registration of the cover assets into a cover register or by transfer of the cover assets to a special entity (SPV or specialised institution). The covered bond legal/regulatory framework should ensure that the establishment of the cover register and/or the transfer of the (cover) assets to a special entity result in legally binding and enforceable arrangements, including in the event of default or resolution of the issuer.*

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5 https://www.eba.europa.eu/documents/10180/534414/EBA+Report+on+EU+Covered+Bond+Frameworks+and+Capital+Treatment.pdf

In light of the above, we do understand that certainty as to bankruptcy protection of the cover pool assets is an essential precondition for the market to develop. Even if it is not necessary in law, such clarity is greatly helpful in seamless development of the market.

There are 2 ways to impact the clarity:

(a) Regulatory pronouncement, such as MAS Singapore Notice 648.
(b) Legislative amendment, as we are proposing below.

Alternative One: Regulatory pronouncement of conditions of ring fencing:

Regulatory pronouncements have been used by several countries, such as Singapore, UK, New Zealand, etc.

In India, one notable precedent of regulatory guidelines trying to provide legal certainty is the "true sale" conditions for securitisation, as spelt by the RBI in its Guidelines on securitisation, of 2006. While true sale may otherwise be a highly contentious issue, the RBI tried to provide a regulatory framework to the same, by containing several features of true sales in the 2006 Guidelines, followed by the 2012 Guidelines. It is generally felt that while such regulatory statements may not be of compulsive force in a court of law, they will have high persuasive value.

Therefore, if a regulatory pronouncement provides the conditions for ring-fencing in covered bonds, that may serve as a reference point for structuring covered bond transactions in India. Notably, the significant conditions for ring fencing, taking cue from transactions structured out of UK, Singapore, etc may be as follows:

1. There is an agreement for assignment of specific assets, identified and ascertained on the day of earmarking the assets to a cover pool. By such agreement of assignment, the assets are agreed to be transferred to a trustee.
2. The trustee is an independent entity.
3. The agreement of assignment provides clear trigger conditions, when the agreement of assignment will mature into a true sale. The true sale characterization is automatic, and in any case, beyond the discretion of the issuer. Necessary power is given to the trustee to perfect the true sale.
4. Once the assets are thus made part of the cover pool, the records of the issuer are marked, so as to make the same assets unavailable for being used in any other manner, whether by way of sale, assignment, borrowing or otherwise.
5. The cover pool is regularly monitored by a cover pool monitor.
6. The issue/seller does not have open-ended rights of withdrawing assets once transferred to the cover pool. The issuer may substitute assets in a cover pool only in case of default, or otherwise as provided in the agreement of assignment.
7. Once the transaction matures into a true sale, the issuer does not have any right of retaining or using the cashflows from the cover pool.
8. The assets forming part of cover pool, while being on the balance sheet of the issuer, are specifically disclosed in the notes to accounts of the issuer. Thereby, it is in public domain that the assets in the cover pool are dedicated to serve the needs of the covered bonds holders.

Alternative Two: Legislative amendments via Bankruptcy Code:

The other alternative is to make legislative amendments, via the Bankruptcy Code.

Bankruptcy Code 2015 or similar law dealing with financial institutions:

The Government has introduced The Insolvency and Bankruptcy Bill, 2015[6] on 21st December, 2015 based on the recommendations of the Bankruptcy Law Reforms Committee[7]. The Bankruptcy Code seeks to replace the present scattered legislative framework for resolution of insolvency in case of companies, LLPs, firms and individuals, into a single consolidated code, and to put the process on a fast track with tight timelines at each stage.

Under Clause 53 of The Insolvency and Bankruptcy Bill, 2015, the order of priority have been defined as follows:

a. the insolvency resolution process costs and the liquidation costs paid in full;
b. the following debts which rank equally between and among the
    i. debts owed to a secured creditor in the event such secured creditor has relinquished security and
    ii. workmen's dues for the period of 12 months preceding the liquidation commencement date;
c. wages and any unpaid dues owed to employees other than workmen for the period of 12 months preceding the liquidation commencement date;
d. amount due to the Central Government and the State Government including the amount to be received on account of the Consolidated Fund of India and the Consolidated Fund of a State, if any, in respect of the whole or any part of the period of 2 years preceding the liquidation commencement date;
e. debts owed to a secured creditor for any amount unpaid following the enforcement of security interest,
    i. any remaining debts and dues,
    ii. preference shareholders, if any; and
    iii. equity shareholders or partners, as the case may be,
    iv. Fees payable to liquidator shall be deducted proportionately from the proceeds payable to each class of aforementioned recipients.

Clause (Section) 53 starts with a non-obstante clause. Thereby, this clause will override any contrary provisions of any other statute, and thereby, may nullify any regulatory pronouncements as well.

Clause 53 (2) states that any contractual arrangements between recipients under sub-section (/) with equal ranking, if disrupting the order of priority under that sub-section shall be disregarded by the liquidator. Since all secured creditors are, by the ranking of priorities, given equal ranking, any super-priorities will be ignored under bankruptcy laws.

The Bankruptcy Code is not to be applicable to banks or financial institutions. It is expected that there will be a separate law to deal with the winding up of financial institutions.

We are of the view that it is important to create a carve-out for capital market transactions, for several reasons. There are several subordinated bonds being issued by banks or financial institutions –these are treated as a part of Regulatory Capital, and subject to conditions, almost at par with Tier 1 capital for banks. The presumption there is that the subordinated bonds are junior to every other creditor of the bank. However, if the Bankruptcy Code applies, all the priority or subordination, contained in contractual documents, will be ignored.

[6] http://www.prsindia.org/uploads/media/Bankruptcy/Insolvency%20and%20Bankruptcy%20code,%202015.pdf
[7] http://finmin.nic.in/reports/BLRCReportVol1_04112015.pdf

Going forward, covered bonds may be issued, not necessarily by financial institutions. One potential issuer may be infrastructure operators. There are instances of covered bonds being issued against shipping assets in Germany. Covered bonds may also be issued against standard assets such as aircrafts.

Therefore, containing a carve-out for capital market transactions in sec. 53 of the Bankruptcy Code will help any super-priority, or subordination, that capital market transactions may want to provide to issuance of bonds or other capital market instruments.

Similar carve out may be given whenever the law dealing with bankruptcy of banks or financial institutions is drawn up.

We suggest the following Explanation may be introduced in sec 53 (1):

> *Provided that, subject to priority for workmen's dues as provided hereinabove, the priority of payments in case of capital market instruments shall be as per the ranking of the relevant security, or class of securities, as disclosed in the offer document for the security.*

Conclusion

We summarize the proposal on the structure and the regulatory changes proposed as follows:

a. Structured covered bonds may be facilitated by favorable regulatory pronouncements, laying down the essential framework for ring fencing;
b. The covered bonds may be issued with segregation of the cover pool in favor of an SPV to ensure bankruptcy ring fencing of the receivables; and
c. Legislative recognition of super-priority or subordination of certain capital market instruments may be provided by appropriate insertion in the Bankruptcy Code, or the proposed law dealing with bankruptcy of financial institutions.

Annexure – 1

Countries facilitating covered bonds issuances

Countries that have issued regulations on Covered Bonds (Legislation Option)		Germany, Spain, Korea, Canada, UK, New Zealand, Italy, Norway, Portugal, Sweden, Finland, Bulgaria, Norway
Korea		On June 29, 2011, Korea brought covered bonds guidelines. These guidelines pertain only to residential mortgage loans or RMBS. The mortgage loans must be prime loans, with LTV of 70% or less, and overdues of not more than 60 days. The guidelines impose a minimum 5% over-collateralisation requirement. Thereafter, in 2014, the Korea Covered Bonds Act was passed to facilitate issuance of covered bonds to reduce Korean household's exposure to interest rate shocks by facilitating long-term finance. The Act requires minimum collateralization of 105% and also with the requirement to limit the covered bond issuance to 8% of total assets of the issuer.
New Zealand		In July 2012, the Reserve Bank of New Zealand released a draft bill of the new legislative framework on the covered bonds. The draft bill amended the Reserve Bank of New Zealand Act, 1989 with a view to provide legal framework to the covered bonds issuances by banks in New Zealand. However the draft bill received official status on 3rd December, 2013 consequent to the royal assent [Reserve Bank of New Zealand (Covered Bonds) Amendment Act 2013- click here]. The bill then came to be known as Reserve Bank of New Zealand (Covered Bonds) Amendment Act 2013. The Bill was drafted with the aim to a) clear segregation of cover pool assets from an issuing bank's other assets; b) make certain the treatment of cover pool assets under legislative provisions that would apply should an issuing bank be placed into statutory management or liquidation. c) make registration of New Zealand banks' covered bond programmes mandatory subject to meeting registration requirements; d) require that cover pool assets be held by a special purpose vehicle (SPV),

		e) have independent monitoring of cover pools by a cover pool monitor; f) clarify the treatment of cover pool assets held by a covered bond SPV in the event that an issuer is placed into statutory management or liquidation g) provide for the Reserve Bank of New Zealand to allow entities other than registered banks to register covered bond programmes under this legislative framework in future.
Countries that have issued regulations on Covered Bonds but do not have bankruptcy related provisions in legal framework		Bulgaria, Finland, Netherlands, Belgium, Austria
Countries that have enabling regulations for issuance of Covered Bonds (Regulatory pronouncement option)		Singapore, Australia
Countries using structured covered bonds (Common law option)		United States of America. Transactions sporadically happen, though there is no covered bond law currently. A law proposed in March 2011[HR 940 – see here],but did not proceed. However, FDIC issued a covered bonds policy statement in 2008[8] basis which covered bond issuances are undertaken.
Countries considering covered bonds issuances		South Africa
		After shunning the use of covered bonds as a funding tool, the South African Reserve Bank is now considering allowing banks to issue covered bonds within two to three years' time frame. The intention to allow issuance of such previously banned securities comes consequent to the banks meeting with the Financial Market Liaison Group held on 29th October, 2015 [FMLG report] The meeting did not though confirm, whether this would be by way of introduction of legislation or otherwise.

[8] https://www.fdic.gov/regulations/laws/rules/5000-1550.html

Regulatory Amendments to facilitate Covered Bonds

SINGAPORE

In December, 2013, the Monetary Authority of Singapore (MAS) issued Directions/ Notice for issuance of covered bonds by banks incorporated in Singapore [MAS 648]. The Directions issued have been further amended in the year 2015 making significant changes in the Directions. The Direction/ Notice only covers issuance of covered bonds and other securitization activities are outside its ambit and will be continued to be covered by MAS 628 Notice. The Direction as amended covers following issues pertaining to issuance of covered bonds by banks incorporated in Singapore –

Features	**Direction**
Covered Bonds definition	"covered bonds" means any bonds, notes or other debentures issued by a bank or an SPV where payment of the liabilities to the holders of such covered bonds and any liabilities arising from the enforcement of the rights of the holders of the covered bonds are: (a) secured by a cover pool; and (b) recoverable from the bank regardless of whether the cover pool is sufficient to pay off such liabilities;
Cover pool definition	"cover pool" in relation to an issuance of covered bonds, means a pool of assets that are – (a) legally or beneficially owned or legally and beneficially owned by the bank or an SPV, (b) held by the bank as trustee, or a replacement trustee, on behalf of an SPV, or (c) both, for the purpose of securing the payment of: (i) the liabilities to the holders of the covered bonds; (ii) any liabilities arising from the enforcement of the rights of the holders of the covered bonds; and (iii) any liabilities to third party service providers appointed for the operation and

	administration of the covered bond programme;
Limit of covered bonds issuances	Residential mortgages transferred to the cover pool shall not exceed 4% of the total assets of the bank
Over-collateral levels	The bank or SPV, as the case may be, shall ensure that the aggregate value of assets in a cover pool shall be at least 103% of the outstanding nominal amount of the covered bonds secured by the assets at all times

AUSTRALIA

In June 2012, the Australian Prudential Regulation Authority (APRA) released a response paper in relation to issuance of covered bonds by Authorized deposit-taking institutions (ADI) and the final Australian Prudential Standard i.e. APS 121 [APS 121] was issued in August 2012. The prudential standard applies to all ADIs other than foreign ADI. The standard stresses on two key requirements which has been given below

1. Adoption of policies and procedures to manage risks relating to issuance of covered bonds
2. Application of an appropriate capital treatment to exposures associated with issuance of covered bonds

The standard covers following provisions:

Features	**Direction**
Covered Bonds definition	As specified in the Banking Act **Covered bonds** (1) ***Covered bonds*** are bonds, notes or other debentures issued by an ADI, liabilities to the holders of which, or their representatives, are: a. recoverable from the ADI; and b. secured by assets beneficially owned by a ***covered bond special purpose vehicle***
Cover pool definition	As specified in the Banking Act, 1959[9] The ***cover pool*** for the covered bonds consists of the assets beneficially owned by the covered bond special purpose vehicle

[9] http://www.austlii.edu.au/au/legis/cth/consol_act/ba195972/

	to the extent that they secure the liabilities to the holders or representatives equally or in priority to any other liabilities.
Bankruptcy ring fencing	The documentation associated with a covered bond issuance must clearly set out: a. the events of default that would enable covered bond holders to access collateral held in the cover pool; b. that claims by covered bond holders on the covered bond special purpose vehicle are limited to assets in the cover pool; c. how assets forming part of the cover pool are identified; d. XXX **Clause 13** When determining whether an asset is part of a cover pool, an issuing ADI must have regard to the priority of claims under all possible scenarios, not just under a business-as-usual scenario.
Limits on covered bonds issuances	An ADI must not issue a covered bond if the combined value of assets in cover pools securing covered bonds issued by the ADI would exceed 8%, or such other percentage as is prescribed by the regulations, of the value of the ADI's assets in Australia.

Annexure – 2

EU model covered bonds framework

Part III of the Consultation Document on Covered Bonds in the European Union[10] issued by the European Commission elaborates on a hypothetical EU covered bond framework based on the structure and elements set out in the EBA Report. The extract of the hypothetical framework is as below:

This Part elaborates on each of the proposed elements for a hypothetical EU covered bond framework as set out under section 3 of Part II, providing a high-level approach that could be reflected in a eventual legal instrument and/or set of recommendations. Both the structure and the proposals are largely based on the best practices recommended by the EBA, although some elements have been added for consideration.

Stakeholders are invited to review and respond to the questions set out under each applicable subsection in this Part. For the avoidance of doubt, references to the "Framework" should be construed as references to any potential EU legal instrument (directive or regulation and potential delegated and implementing acts) and/or recommendations to Member States in accordance with the two Options outlined under section 3 of Part II, in each case as appropriate. References have been made to EBA or ESMA supervisory guidelines where these could be envisaged.

1. COVERED BOND DEFINITION

1.1 New legal definition

The Framework could repeal the current definition of "covered bond" set out in Article 52(4) of the UCITs Directive with a new definition that would describe these as secured debt instruments issued by credit institutions and meeting all other applicable requirements laid out therein. The three key elements of Article 52(4) (see section 1 of Part II) would be duly replicated and expanded as part of the new EU covered bond Framework. However, the first requirement on the location of the issuer could be supplemented with a system of recognition of "equivalent third countries" for issuers with their registered office in a non-EEA country (see subsection 1.3 of this Part below).

The legal definition of "covered bonds" under the Framework could be supplemented with the following:

- the term "regulated" could be added to the legal denomination to distinguish qualifying covered bonds from non-qualifying instruments using covered bond structures; and/or
- a system of certification of qualifying instruments which could be added to a list maintained by ESMA or EBA.

For the sake of clarity and transparency towards investors and in order to avoid contagion from lower quality instruments in a crisis, the Framework could protect the denomination “covered bonds” or "regulated covered bonds" and that of qualifying national instruments (Pfandbrief, etc.) and limit their use in marketing materials to instruments that conform to the European Framework.

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[10] http://ec.europa.eu/finance/consultations/2015/covered-bonds/docs/consultation-document_en.pdf

In the event of an alternative EU law framework (29th Regime), covered bonds issued under the Framework would coexist with covered bonds issued under Member States' laws. Accordingly, the Framework would have to take due account of both for legal definition and protection of denomination purposes.

1.2 Interaction with prudential requirements

As the Framework would replace the definition of covered bonds in Article 52(4) of the UCITS Directive, all references to "covered bonds" in EU law currently relying on this Article should instead refer to the new legal definition in the Framework which, accordingly, would set out the relevant conditions for the eligibility of covered bonds for all applicable prudential regulatory purposes.

In relation to Article 129 CRR, the provisions in the Framework dealing with the cover pool and transparency could be used as new criteria for the assignment of preferential risk weights and replace the high level criteria set out in that Article.

1.3 Equivalent covered bonds in third countries

The Framework could provide for the identification of "equivalent covered bonds" issued by credit institutions with their registered office in a non-EEA country, in particular for the prudential regulatory purposes referred to subsection 1.2 of this Part. The equivalence assessment would look into whether:

- the relevant third country has covered bond laws in force which are equivalent to the EU covered bond Framework in terms of: (i) public supervision; (ii) double recourse; (iii) insolvency remoteness for bondholders; (iv) eligible cover assets and protection from cover pool risks (including overcollateralisation); and (v) transparency;
- the third country performs public supervision in an equivalent way;
- the eligible assets for the cover pool in the relevant third country are subject to equivalent characteristics and underwriting standards to those applied to eligible assets under the Framework; and
- the relevant third country applies prudential and regulatory requirements to issuing credit institutions at least equivalent to those applied in the European Union, as per Article 107(4) of the CRR.

Third country covered bond regimes assessed as "equivalent" would be published on a list maintained and updated on a regular basis by ESMA or EBA.

2. COVERED BOND ISSUERS AND SYSTEM OF PUBLIC SUPERVISION

2.1 Issuer models and licensing requirements. Role of SPVs

As illustrated in the EBA Report (see Table 5), Member State laws provide for different covered bond issuer structures, which can be broadly classified as follows:

- "universal" credit institution issuer models, where a credit institution with diversified business and funding sources issues the covered bonds directly. It is noted that in this model the cover assets remain on the balance sheet of the issuer but are legally ring-fenced in favour of the covered bondholders and these have a preferential claim over the assets;

- "specialised" credit institution issuer models, where the issuer is legally restricted in the range of business activities it can engage to lending or acquiring certain qualifying assets and funding those activities mostly or exclusively through the issue of covered bonds backed by those assets. This model features different structures, from mortgage banks as in Denmark or Luxembourg that both lend to end-customers and issue covered bonds, to instrumental-type of issuers such as the French *Sociétés de Financement de l'Habitat* or *Sociétés de Credit Foncier* ("**SCF**") which issue covered bonds on the back of assets originated by other credit institutions which are typically part of the same group;

- structures with "universal" credit institution issuers establishing unregulated special purposes vehicles (SPVs) at issuance as an insolvency remote company to which the cover assets will be transferred in the event of issuer's failure/default (UK, Italy and the Netherlands). The Report explains that this structure is used as a means "to enhance the extent of segregation of the cover assets from the issuer and, therefore, to enhance the quality and legal reliability of the priority claim enjoyed by the investor on the cover assets".

In addition, as shown in Table 26 of the EBA's Report there is a multiplicity of licensing systems across Member States which may include: (i) credit institution licensing; (ii) one-off covered bond-specific licensing; (iii) authorisation prior to each covered bond programme; (iv) notification of each covered bond programme; or (v) notification of each covered bond issue (within a programme). Ad-hoc licensing requirements (that is, those in addition to credit institution licensing) are due to the existence of specific prudential requirements on covered bond issuers beyond those applying to credit institutions generally under the CRR.

The EU Framework would seek to recognise all existing issuer models as described above in accordance with the following principles:

- any credit institution authorised in any Member State as such in accordance with the CRR (Article 4.1(1)) and the CRD would be permitted to issue qualifying covered bonds;

- specialised covered bond issuers authorised in accordance with ad-hoc national laws would also be qualifying issuers under the Framework provided they complied with the specific requirements set out in those laws. For clarity, the Framework could include a list of such issuers and their applicable laws;

- the use of SPVs and pooled structures could be expressly permitted, both to ringfence cover assets as in existing models or as issuers on the back of pools of cover assets originated by other credit institutions.

It would appear desirable to streamline the multiplicity of licensing systems for issuers and programmes and harmonise the additional prudential requirements applicable to covered bond issuers, provided that a reasonable common ground can be found between the various legal systems.

2.2 On-going supervision and cover pool monitoring (pre-insolvency)

The on-going supervision of covered bond issuers and programmes comprises a variety of oversight actions undertaken by competent authorities post-licensing of the issuer and/or programme and prior to the issuer's becoming insolvent or in resolution. The EBA Report notes that on-going supervisory practices cover the following areas:

– implementation of regular on-site inspections;

– implementation of supervisory guidelines specific to covered bond issuance business;

– issuer reporting requirements;

– supervision of asset eligibility and asset valuation criteria;

– supervision of coverage calculations;

– prompt corrective action practices; and

– on-going monitoring of the cover pool.

As noted in subsection 2.1 of this Part, the establishment of and amendments to covered bond programmes are subject in many Member States to ad-hoc licensing/authorisation or notification requirements, in relation to which a specific question has been put forward as to whether it would be desirable to harmonise and simplify such processes.

As the EBA Report recommends, the EU covered bond Framework should provide for a "clear and sufficiently detailed illustration of the duties and powers of the competent authority regarding the on-going supervision of the applicable activities/regulatory requirements of covered bond issuers". A common set of duties and powers for all competent authorities based on high quality standards would contribute to enhancing confidence in European covered bond markets and improve investor protection.

As noted in the EBA Report, many covered bond laws of Member States require cover pools to be monitored by an independent third party (the "**cover pool monitor**") appointed by the competent authority or the issuer as an additional layer of review of compliance by the issuer with certain legal obligations. For instance, cover pool monitors typically perform audits on the cover pool, verify compliance with coverage tests and report directly to the competent authority. Accordingly, an EU covered bond Framework could provide for the following:

- a requirement on the issuer or the competent authority to appoint an independent third party as monitor of the cover pool;
- professional eligibility criteria that a person or legal entity should meet to be appointed as cover pool monitor;
- specific duties that the cover pool monitor would be bound to, tasks that he or she should perform and a liability regime; and
- a passporting mechanism that would allow cover pool monitors to offer their services in other Member States.

2.3 Covered bonds and the SSM

The Single Supervisory Mechanism established by SSM Regulation gives direct supervisory powers to the European Central Bank (ECB) on the largest credit institutions in the Euro area and in those non-Euro Member States that choose to join the SSM (the "**Participating Member States**"), while national competent authorities retain direct supervisory powers on the remaining credit institutions in the participating Member States.

The SSM Regulation imposes certain tasks on the SSM among which ensuring compliance of credit institutions with "EU banking rules" is expressly included. In addition, the SSM is tasked with an explicit duty to:

*"carry out **supervisory reviews**, including where appropriate in coordination with EBA, stress tests and their possible publication, in order **to determine whether the arrangements, strategies, processes and mechanisms put in place by credit institutions and the own funds held by these institutions ensure a sound management and coverage of their risks**, and on the basis of that supervisory review to impose on credit institutions specific additional own funds requirements, specific publication requirements, specific liquidity requirements and other measures, where specifically made available to competent authorities by relevant Union law".*

Covered bonds have significant implications for the prudential soundness and orderly resolution of credit institutions, in particular as major contributors to a credit institution's asset encumbrance and, accordingly, the SSM takes into account covered bond issuance in the performance of their tasks. However, the SSM is not responsible for the special supervision of covered bond issuers and cover pools, which remain an exclusive domain of national competent authorities (either the banking or the markets authority) in accordance with their national laws.

Against the backdrop of the SSM's supervisory review duties and more broadly the objectives of Banking Union, it would seem appropriate to consider whether ECB should have a more specific supervisory role on the special supervision and monitoring of covered bond issuance by credit institutions falling within the scope of the SSM.

3. DUAL RECOURSE AND INSOLVENCY/RESOLUTION REGIME

3.1 Definition of dual recourse principle

The dual recourse principle is enshrined in Article 52(4) of the UCITS Directive and constitutes one of the key features of covered bond legislation in the EU. In reflecting the same principle, the Framework could provide that "regulated" covered bonds must grant the bondholder:

- a direct claim against the cover pool on an absolute priority basis upon default of the issuer. "Absolute priority basis" means that the proceeds from the cover pool must be

  applied to repay principal and interests due to bondholders in priority to all other creditors of the issuer. The issuer's default may be triggered upon its resolution or declaration of insolvency; and

- a full recourse claim against the issuer for the timely repayment of principal and payment of interests attached to the covered bonds. "Full recourse" means that bondholders must be entitled to the proceeds from the liquidation of the issuer's insolvent estate as "unsecured creditors" for any deficit that may result from applying the proceeds of the cover pool to meet all liabilities due to them on an absolute priority basis as set out above.

Key to the effective implementation of the dual recourse principle is a robust insolvency and resolution regime that ensures the segregation of the cover assets upon insolvency/resolution of the issuer and the on-going administration of the cover pool. The Framework would seek to implement the best practice principles advocated by the EBA Report on both asset segregation and insolvency remoteness as discussed below.

3.2 Segregation of the cover assets

Consistent with a majority of Member States' covered bond laws, the Framework could provide for a clear and effective mechanism to identify cover assets at pre-insolvency/resolution stage by requiring issuers to maintain a register of cover assets. Further consideration should be given to the possibility of using SPVs as an additional segregation mechanism, as currently required in some Member States' laws. The form and content of the asset register could be harmonised through primary or secondary legislation or EBA/ESMA supervisory guidelines. Further, as recommended by the EBA, the segregation should encompass all primary assets, substitution assets and derivatives entered into to hedge risks arising from the covered bond programme.

It may also be desirable for the Framework to impose an obligation on the issuer to have a detailed plan in place setting out operational procedures that ensure the orderly segregation and on-going operation of the cover pool as an independent entity upon the issuer's insolvency/resolution. In particular, the issuer should be required to keep loan documentation up-to-date and readily accessible for the cover pool administrator to be able to take over management of the pool and enforce any connected rights and security.

3.3 Administration of the cover pool post insolvency/resolution of the issuer

Following the segregation of the cover pool, this must be administered as a separate entity with a view to fulfilling the payment obligations towards the bondholders and other counterparties. Consistent with the best practice principles advocated by the EBA Report, the Framework could apply the following provisions with regard to the administration of the cover pool:

– legal form and supervision of the cover pool: it may be appropriate to require the cover pool to be incorporated as a regulated entity, as currently required by the covered bond laws of some Member States, in order to place the cover pool and its administrator under public supervision.

– appointment and duties of the special administrator: the on-going management of the cover pool should be subject to special administration. The Framework could specify the following set of requirements in relation to the special administrator of the cover pool:

    a) eligibility requirements: the special administrator should be an officer of the court and, accordingly, only those that may act as insolvency practitioners in each Member State would be eligible to be appointed;

    b) power to appoint and remove: the special administrator should be appointed by and accountable to the insolvency court. However, the competent authority or the resolution authority should be given a role in the appointment process (for instance, right to be heard or right of initiative to put forward candidates to the court for appointment);

    c) duties and powers: the special administrator's primary duty should be to act in the interests of the bondholders as a whole and should perform his or her functions with the overriding objective of settling in full the liabilities of the cover pool. The special administrator should be given a range of powers which are adequate and sufficient to carry out his or her primary duty and overriding objective; and

d) liquidator of the issuer: where national covered bond laws provide for the liquidator of the issuer to act at the same time as administrator of the cover pool, the above should apply to the liquidator in its role as special administrator.

– ranking of cover pool liabilities: the bondholders should continue to benefit from a priority claim on the proceeds of the cover pool, both during the on-going operation of the cover pool as an independent entity and at the time it is wound up. However, the Framework could permit to give absolute priority (thus ranking ahead of the bondholders) to any expenses properly incurred by the special administrator or the liquidator in connection with the cover pool, in which case the nature of such claims and when they could be considered adequate may have to be defined. Further, the claims of the following creditors of the cover pool could be allowed to rank *pari passu* with the claims of the bondholders:

  a) persons providing services to the cover pool;

  b) counterparties to hedging instruments which may be incidental to the maintenance and administration of the cover pool or to the terms of the covered bonds; and

  c) persons (other than the issuer) providing a loan to the cover pool to enable it to satisfy the claims of any of the above persons.

3.4 Interaction between cover pool and issuer in insolvency/resolution

As a result of the operation of the dual recourse mechanism, the cover pool may need to continue interacting with the insolvent estate and/or the successor credit institution following respectively the issuer's insolvency or resolution under two possible scenarios:

– where settlement of the covered bonds in full delivers excess collateral, this must be returned to the successor credit institution or the insolvent estate, as the case may be; or

– where covered bonds cannot be settled in full with the cover assets alone, bondholders will have a residual claim as unsecured creditors against the insolvent estate and/or the successor credit institution.

However, the cover bonds and the successor credit institution or estate may not have the same life expectancy, which may give rise to uncertainty of outcomes for both bondholders and the remaining creditors of the issuer. For instance, the long maturity of the cover bonds may lead to protracted resolution and insolvency proceedings during which the successor credit institution and/or insolvent estate remain liable for possible residual claims from the bondholders.

Finality could be provided with a clear cut-off mechanism that would release the insolvent estate and/or successor credit institution from possible residual claims after a given date and provided that adequate protections for bondholders were put in place.

In addition, the Framework could lay down an explicit role with clear powers and duties on resolution authorities as part of a cut-off mechanism for covered bonds. For instance, resolution authorities could be given express powers to set a maximum level of permitted overcollateralisation ("**OC**") either in the on-going life of covered bond transactions or at the time of resolution or insolvency of the issuer or to appoint a valuer for the cover pool.

QUESTIONS – INTERACTION BETWEEN COVER POOL AND ISSUER IN INSOLVENCY/RESOLUTION

1. **Are current provisions in EU law sufficient to deliver effective protection for boldholders in a resolution scenario involving covered bonds? In particular, is it sufficiently clear:**

   a) **how the cover pool would be segregated under each possible resolution or recovery scenario of the issuer?**

   b) **how the full recourse against the issuer would take effect if the issuer is in resolution and is not placed subsequently into liquidation?**

   c) **what procedural steps should be followed in resolution and by whom in order to make effective the dual recourse mechanism?**

2. **Should the Framework provide for a cut-off mechanism as suggested in subsection 3.4 of Part III? In particular, should such a cut-off mechanism:**

   a) **preclude the closure of insolvency or resolution before possible residual claims from the covered bondholders against the issuer or the insolvent estate have been identified and quantified?**

   b) **set out clear and objective requirements on the valuation of the cover pool and the timing for such valuation?**

c) **extinguish the residual claim on the estate or the successor credit institutions after sufficient assets have been segregated for the benefit of covered bondholders at the outset of the resolution or insolvency proceedings?**

d) **give specific powers and duties to the resolution authority and, if so, what should those consist in?**

4. THE COVER POOL

As set out in the EBA Report, the features of the cover pool affect the performance of covered bonds and, ultimately, the risk that both interest and principal payment obligations may not be fulfilled as they become due. In particular, the Report highlights the following as main cover pool-related risks: (i) the credit risk associated with the underlying obligors; (ii) the recovery capacity associated with the loans; (iii) concentration risks at geographical, asset-class, individual underlying obligor or financial sector-specific levels; (iv) market and liquidity risks of the underlying assets following the issuer's default; (v) the type of security over the underlying assets and their collateralisation mechanism, including the enforceability of the security over the underlying assets; and (vi) the quality and quantity of substitution assets in the cover pool.

All covered bond laws of Member States address the above risks to different degrees with specific provisions on the nature and characteristics of the cover pool and its management by the issuer. This section outlines various similar provisions that could be proposed to the same end as part of the Framework. Insofar as practicable, the Framework would attempt to find common ground between the laws of Member States in this area while at the same time applying the best practice principles advocated by the EBA.

As pointed out in subsection 1.2 of this Part, the provisions in the Framework dealing with the cover pool would be used as new criteria for the assignment of preferential risk weights and, accordingly, these would replace the equivalent high level criteria set out in Article 129 of the CRR.

4.1 Eligible assets: qualifying criteria and requirements

- ***Residential and commercial loans***

  The Framework could allow both residential and commercial loans as eligible assets for cover pool purposes, provided that they meet certain minimum eligibility criteria as described below:

– definition and legal requirements: "residential and commercial loans" as an asset class would include two subcategories of assets:

a) mortgage loans granted to a borrower for residential or commercial purposes where the borrower's obligation to repay principal and pay interests are secured for the benefit of the lender by a security or lien on the property. Mortgage loans would be subject to the following legal requirements:

   i) perfection of security: the mortgage should be legally valid and enforceable against the borrower in accordance with the applicable law at the time the loan is added to the cover pool;

   ii) first ranking: the mortgage should be a "first ranking mortgage", although this requirement should be defined taking into account certain charges or encumbrances with an explicit priority in law or in statute (eg levies on the property);

b) in France, guaranteed residential loans meeting the qualifying criteria set out in Article 129(1)(e). As recommended by the EBA, these loans could be subject to an additional requirement that the law governing the covered bonds should not preclude the administrator of the cover pool from creating mortgages over the loans included in the cover pool where the guarantee, for any reasons, has ceased to exist following the issuer's default;

– loan-to-value (LTV) ratio(s) and valuation requirements: residential and commercial loans should be subject to specific maximum LTV ratios, defined as a limit on the principal of the loan relative to the value of the property. As shown in the EBA Report (see Table 13), the covered bond laws of Member States apply LTV ratios of different types and subject to varying criteria and limits. However, common features to a majority of laws which the Framework could seek to apply would include:

   a) a distinction between, at least, residential and commercial loans to set different LTV limits (more conservative for the latter);

   b) setting LTV limits for the calculation of collateralisation coverage levels and, in some cases, for the eligibility of individual loans as well;

   c) a requirement that LTV levels apply for the entire lifetime of the covered bonds;

   d) a further requirement that LTV levels be measured on a specified property value (either "market value", "mortgage lending value" or variants thereof) and updated regularly;

e) a recognition of privilege for any excess over the LTV cap, in accordance with which covered bondholders will be entitled to that excess on a priority basis in the event of liquidation of the cover pool.

As advocated by the EBA, the valuation of the properties should be based on transparent valuation rules and be carried out by a valuer that is independent from the credit granting process;

– location of assets: as a general principle, cover pools should be permitted to comprise residential and commercial loans secured by properties located in any Member State of the European Union and the European Economic Area and with no jurisdiction-based limits. Residential and commercial mortgage loans in third countries should be allowed in the cover pool where they are located in jurisdictions assessed as "equivalent third countries" (see subsection 1.3 of this Part);

– non-performing loans should be completely excluded from the cover pool. This would exclude loans that were non-performing at the time of issuance and loans that become non-performing at any time after issuance which the issuer would be obliged to replace in the cover pool.

In relation to mortgage-backed securities (RMBSs and CMBSs), the EBA Report notes that a handful of Member States covered bond laws allow for the inclusion of senior tranches of RMBSs and/or CMBSs in cover pools under various conditions. However, in making a recommendation on whether the CRR should retain the derogation provided for in Article 496 of the CRR, the EBA expresses overarching prudential concerns on the use of RMBSs or CMBSs as cover assets in excess of the 10% threshold as currently permitted by that Article and, accordingly, suggests removing the derogation after 31 December 2017. EBA's concerns are mainly due to:
(i) the added legal and operational complexity resulting from the double layer structure provided by the covered bonds and the tranche of securitisation instruments backing those; (ii) the potential for conflicts of interest that may arise as a result of the provision in the derogation in Article 496 requiring a member of the covered bond issuer's group to retain the whole first loss securitisation tranche backing the senior securitisation tranches in the event of issuer's default; and (iii) potential conflicting requirements on transparency and due diligence between the covered bond programme and the underlying securitisation instruments.

QUESTIONS – RESIDENTIAL AND COMMERCIAL LOANS

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

2. **In relation to mortgage loans:**

   a) **what are your views on the proposed requirements on "perfection of security" and "first ranking mortgage"? Is registration of the security a requirement for perfection in your jurisdiction?**

   b) **is the enforceability of mortgages in the different Member States equivalent or should there be additional requirements to ensure their equivalence?**

   c) **are minimum standards for mortgage rights in third countries necessary?**

3. **In relation to LTVs:**

   a) **what are your views on the proposals set out in subsection 4.1 of Part III on minimum LTVs?**

   b) **in the case of insured properties, should higher LTV limits be allowed if the insurance cover meets certain requirements and, if so, what should such requirements be? In what other cases should higher LTV limits be allowed? Could loan-to-income requirements be used to replace or complement LTV limits?**

   c) **should there be an additional average LTV eligibility limit at portfolio level?**

   d) **with the advent of a Binding Technical Standard defining Mortgage Lending Value, is it appropriate to apply this for eligibility in all cover pools across the Union as a prudent measurement?**

   e) **should LTV limits be used to determine: eligibility (loan in/out) of loans at inception? Eligibility (loan in/out) of loans on an ongoing basis? Should they instead be used to simply determine contribution to coverage? A combination of the above?**

4. **In relation to the valuation of cover assets:**

   a) **how frequently should the value be updated and in which way (revaluation, update of the initial valuation, and in which way)?**

   b) **what criteria should be applied to (i) the valuer and (ii) the valuation process to ensure that they meet the transparency and independence principles set out in the first and second subparagraphs of Article 229(1) CRR?**

5. **Should the Framework adopt the definition of "non-peforming exposures" as set out in the EBA's draft Implementing Technical Standards on Supervisory Reporting on Forbearance and Non-performing Exposures[8]?**

6. **In light of the EBA's prudential concerns in relation to the use of RMBSs and/or CMBSs in cover pools, should the Framework exclude these assets completely from qualifying as cover assets (including, for these purposes, as substitution assets) or should they be allowed only subject to strict criteria and within the 10% limit currently permitted under Article 129 of the CRR? What is the added value and practical uses of RMBS/CMBS as collateral in your jurisdiction/issuer?**

- ***Public sector loans***

As permitted by a majority of Member States covered bond laws, the Framework would allow public sector loans in Member States of the Union and the EEA as cover assets and these should not be subject to any jurisdiction-based limit. Eligible public sector loans would include loans to or exposures guaranteed by the following:

– any central government and central bank of Member States of the EU and the EEA; and

– regional governments, local authorities and public sector entities within Union and EEA Member States, provided that exposures to those are treated as exposures to their central governments in accordance with Articles 115 and 116 of the CRR or, otherwise, they meet other qualifying criteria such as a minimum external rating or credit quality step.

Loans to and exposures guaranteed by central governments, central banks, regional governments, local authorities or public sector entities in third countries and certain international organisations would also be allowed as cover assets provided that following requirements were met:

– the third country has been assessed as an "equivalent third country" (see subsection 1.3 of this Part);

– the loans meet in each case the requirements set out in Article 129 of the CRR; and

– the loans fall within the limits for mixed pools (see below subsection on mixed pools).

QUESTIONS – PUBLIC SECTOR LOANS

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

2. **What eligibility requirements in terms of validity and enforceability should apply to the guarantee granted by the relevant public sector entity?**

- ***Other assets: Aircraft, Ship and SME loans***

The EBA Report notes that only the covered bond laws of Luxembourg and Germany allow aircraft loans as cover assets, whilst this type of covered bonds is not included within the scope of Article 129 of the CRR. In its technical advice to the Commission in accordance with Article 503(3) of the CRR, the EBA expresses prudential concerns on the potential inclusion of aircraft loan-backed covered bonds within the scope of the preferential risk weight treatment, in particular due to: (i) lack of sufficient and reliable public historical evidence over default and loss behaviour of aircraft loans; (ii) volatility and pro-cyclicality of the aircraft value; (iii) complexity of the aircraft valuation process; (iv) limited number of lenders in the aircraft finance sector and issuers of these covered bonds; and (v) specific legal issues such as the limited mutual recognition of the security over the aircraft between jurisdictions.

Although EBA's opinion is expressed for preferential risk weight purposes, it casts doubts more generally on the adequacy of aircraft loans to qualify as cover assets given the stated objective of developing a Framework of "regulated covered bonds" based on high standards and best practices. Some of these concerns could be raised in relation to other assets such as ship loans and loans to SMEs.

QUESTIONS – OTHER ASSET CLASSES: AIRCRAFT, SHIP AND SME LOANS

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

2. **In relation to SME loans, is it possible to identify a category of "prime" SME loans as a potential eligible asset class for cover pools?**

- ***Mixed pools and limits on exposures***

  A majority of Member States' covered bond laws allows for more than one asset class in the cover pool, although some laws may impose specific limits on certain types of assets within the pool. The EBA report recommends setting regulatory limits on the composition of mortgage pools as a means of maintaining the risk profile of the cover pool throughout the life of the transaction. However, the EBA also acknowledged in its Report that "other tools may equally ensure consistency and stability in the composition of mixed pools, including contractual arrangements (…) and the supervision on the composition of mixed pools based on supervisory guidelines".

  It seems appropriate to allow generally mixed-asset cover pools as a useful instrument to mitigate concentration risk within the pool and provided that adequately conservative valuation and LTV criteria are followed (as per above). However, limits on certain specific cases could be considered, for instance:

  - assets representing exposures to credit institutions and investment firms should be limited to 15% of the nominal amount of outstanding covered bonds consistent with Article 129(1)(c) of the CRR;

  - similarly, exposures to public sector loans in third countries should be limited to 20% of the nominal amount of outstanding covered bonds consistent with Article 129(1)(b) of the CRR. Specific limits could be applied as well to mortgage assets with properties located in third countries;

  - in France, the 35% limit on guaranteed loans for *obligations foncières* should continue to apply; and

  - a concentration limit at the level of the individual obligor's name in the underlying exposures and exposures to credit institutions could also be considered.

QUESTIONS – MIXED POOLS AND LIMITS ON EXPOSURES

1. **Do you agree that mixed-asset cover pools should be allowed?**

2. **What are your views on the proposed limits on specific assets and concentration of exposures? Should any other limits or requirements apply?**

4.2 Coverage requirement and overcollateralisation

The "coverage requirement" underpins all the covered bond laws of Member States insofar as those implement the principle set out in Article 52(4) of the UCITS Directive. This Article provides that "covered bonds shall be invested in accordance with the law in assets which, during the whole period of validity of the bonds, are capable of covering

claims attaching to the bonds and which, in the event of failure of the issuer, would be used on a priority basis for the reimbursement of principal and payment of the accrued interest". The requirement is, however, implemented differently across Member States, with the EBA Report describing three possible formulations either as:

– nominal coverage: the nominal amount of all cover assets must be at all times at least as high as the nominal amount of outstanding covered bonds; or

– net-present value coverage: the net present value of the cover assets must be at all times at least as high as the net present value of all outstanding covered bonds, which involves using a yield curve to discount future cash flows; or

– net-present value coverage under-stress: same as the preceding but with the added requirement that the coverage must hold even following the implementation of yield curve stress tests, currency tests and other forms of stress tests mandated by the law or regulations. The EBA reports that covered bond laws of Member States using this formulation apply different stress test requirements, some simply stating the obligation to conduct stresses on the covered bonds and cover assets, while some others prescribed detailed features for such stress tests.

The Framework could at least reformulate the coverage requirement to include explicit coverage over all liabilities of the covered bond programme as recommended by the EBA, thus including both the liabilities towards bondholders and other parties involved in the process of covered bond issuance and management such as counterparties in derivative contracts, managers, administrators, servicers, trustees, the cover pool monitor and any other relevant parties. It may also be desirable for the Framework to define the coverage requirement in more precisely quantified terms in accordance with, at a minimum, one of the three options outlined above.

QUESTIONS – COVERAGE REQUIREMENT

1. **Which option should be preferred for the Framework to formulate the coverage requirement and why?**

    a) **a general requirement along the lines of Article 52(4) of the UCITS Directive, amended to include the wording suggested by the EBA;**

    b) **a nominal coverage;**

    c) **a net-present value coverage;**

    d) **a net-present value coverage under stress; or**

    e) **any other or a combination of the some or all of the above.**

2. **If the coverage requirement were formulated as net-present value coverage under stress, should the stress tests be specified in any form in the Framework or ESMA/EBA regulatory guidelines? If so, what specific stress tests should be required and why?**

    Should derivatives entered into in relation to the cover pool be taken into account for the purpose of determining the coverage requirement? If so, what valuation metric should be used for these purposes?

4. **What exposures to credit institutions within the pool should be taken into account to determine the coverage requirement and why?**

The EBA also notes the lack of consistency between the covered bond laws of Member States in setting a minimum level of OC ranging from the absence of such requirement to values above 40%. Against this backdrop, the EBA recommends setting a "quantitative legal/regulatory minimum over-collateralisation level" as a best practice to safeguard the credit quality of the covered bonds, noting the need to carry out further analysis on a number of intervening factors (including, for example, whether there should be different levels depending on the cover asset class or the interaction with the chosen definition of coverage requirement).

Higher levels of voluntary OC increase asset encumbrance in the issuer's balance sheet and, therefore, may detriment unsecured creditors in resolution and insolvency. As explained in subsection 3.4 of this Part, it may be appropriate to impose limits on the maximum levels of OC that should be permitted either in the ongoing life of covered bond transactions, in resolution/insolvency of the issuer or both in order to provide cut- off to both bondholders and the remaining creditors of the issuer.

The OC level would be calculated on the same basis as the coverage requirement where the latter is formulated in accordance with one of the precisely quantified options outlined above. The duties of the cover pool monitor as referred to in subsection 2.2 of this Part would include monitoring compliance with the mandatory OC level requirement and reporting it to the competent authority.

QUESTIONS – OVERCOLLATERALISATION

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

2. **If a mandatory minimum OC level were set in the Framework, should there be exceptions to the requirement? (for example where the issuer applies a precise "match funding model" or where certain targeted liquidity and market risk mitigation measures are used – see subsection 4.3 of Part III)**

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

4. **Should the Framework provide for the treatment of voluntary OC in the event of insolvency/resolution of the issuer?**

4.3 Cover assets/liabilities risk mitigation: market and liquidity risks

The EBA notes in its Report that OC levels, both baseline and under stress when coupled with the coverage principle of net present value under stress, are the "main mitigation tool for most risks arising in covered bond programmes, including interest rate risk".

In addition to mandatory minimum OC levels, careful consideration should be given to the opportunity of imposing targeted market and liquidity risk mitigation requirements as set out in this subsection.

- ***Use of hedges***

  The Framework could include an explicit obligation on issuers to hedge interest rate risk and currency risk in the cover pool and the following limits on the use of hedges consistent with the recommendations set out in the EBA Report:

  – limit on the use of derivative contracts: the use of such contracts in covered bond programmes may be allowed only for risk hedging purposes;

  – limit on the eligibility of derivatives' counterparties: the covered bond issuer may only enter into derivatives with a narrowly defined set of counterparties (i.e. on the basis of rating and/or legal status);

- prohibition of intra-group hedging;
- requirement that derivatives continue following the insolvency or resolution of the issuer; and
- preclude the priority of derivatives' counterparties' claims, which are only allowed to rank *pari passu* at best with the claims of covered bondholders (this item was discussed in subsection 3.3 of this Part).

- ***Management of cashflow mismatches***

  The Framework could set out specific provisions to prevent or manage potential mismatches between the timing of cashflows on the cover assets and those of the covered bonds following segregation of the pool from the issuer. Potential provisions to that end as recommended by the EBA Report could include:

  - an explicit ban on the acceleration of the payment obligations attached to the covered bonds upon insolvency or resolution of the issuer, as currently required by most Member States' covered bond laws. This ban could be supplemented with an explicit power for the special administrator to implement "structural mitigants" of liquidity risk such as soft bullets or conditional pass-through structures as described in the Report;
  - a requirement on issuers to hold a buffer of liquid assets calibrated "to cover the cumulative net out-flows of the covered bond programme over a certain time frame";
  - a requirement on the issuer and the special administrator to conduct liquidity tests within a given timeframe ahead of principal or interest payment maturity; and
  - special exceptions for fully matched funding structures, where the maturity and interest rate features of the covered bonds match those of the cover assets.

  The requirement to hold a buffer of liquid assets in particular should be the subject of further analysis, both as regards its calibration and scope, as noted by the EBA, and also the manner in which it could interact with other liquidity mitigation requirements.

QUESTIONS – MARKET AND LIQUIDITY RISKS

1. **In your view, are OC levels adequate to mitigate market and liquidity risks in the absence of targeted measures such as those described in subsection 4.3 of Part III?**

2. **Should the Framework lay down specific requirements on the use of derivatives as suggested in subsection 4,3 of Part III? How should "eligible counterparties" be defined for the purposes of entering into permitted derivatives?**

3. **What are your views on the potential provisions on the management of cashflow mismatches suggested in subsection 4.3 of Part III? In particular:**

   a) **for issuers, do cashflow mismatches between cover assets and covered bonds arise in your jurisdiction and/or transactions, and, if so, in which way? Are you able to describe a scenario for the timely repayment of the covered bonds? Do you plan for contingencies? Are such scenarios and contingencies disclosed to investors?**

   b) **for investors, do you understand how such cashflow mismatches would be dealt with in practice? Would it be beneficial from your perspective to get systematic information about cashflow mismatches and how these would be managed?**

4. **On the EBA's liquidity buffer recommendation:**

   a) **should covered bond issuers hold a "liquidity buffer" to mitigate liquidity risk in the cover pool and, if so, in what circumstances?**

   b) **should the buffer be calibrated to cover the cumulative net out-flows of the covered bond programme over a certain time frame? What length of time should be used as a time frame for calibration purposes?**

   c) **what eligibility criteria should liquid/substitution assets meet to qualify for the purposes of this buffer?**

5. TRANSPARENCY REQUIREMENTS

Transparency towards investors refers to the information on the cover bonds, the cover assets and the issuer that investors receive at issuance and thereafter on an on-going basis to carry out their own risk analysis on the covered bonds. The EBA Report notes that transparency and disclosure practices and requirements in European covered bonds are highly fragmented and inconsistent due to various factors, notably the differences in issuer models, types of cover assets and national legal and regulatory frameworks.

From an EU law perspective, issuers of covered bonds are subject to the disclosure requirements in Directive 2003/71/EC (the "**Prospectus Directive**") and Regulation (EC) No 809/2004 (the "**Prospectus Regulation**"). Under these legal instruments, information must be made available on the issuer itself and debt securities issued by it, but unlike in the case of asset-backed securities there are no provisions in them dealing with covered bonds as distinct debt securities or with their cover assets. Furthermore, the Prospectus Directive and Regulation apply to public offers of securities and admission to trading on regulated markets. Since, as seen in Part I, a significant segment of the covered bond market is placed with investors through private placement and not through public offers and are also subsequently not listed, this segment would be typically outside the scope of the prospectus regime.

A specific disclosure provision is included in paragraph 7 of Article 129 of the CRR which lays down certain minimum disclosure standards and a semi-annual disclosure regularity as conditions for the credit institution investing in the covered bonds to benefit from the "preferential risk weights" set out in that Article. Under this provision, the issuer must make available information on:

– the value of the cover pool and outstanding covered bonds;

– the geographical distribution and type of cover assets;

– loan size, interest rate and currency risk;

– the maturity structure of the cover assets and covered bonds; and

– the percentage of loans more than 90 days past due.

EBA notes "investors' uncertainty about the compliance of certain covered bond programmes with Article 129 of the CRR" as this provision "may leave excessive room for interpretation for both issuers and competent authorities". Against this background, the EBA recommended in its Report that a legal/regulatory covered bond framework "require covered bond issuers to disclose data on the credit risk, market risk and liquidity risk characteristics of the cover assets and the covered bonds of a given programme (…) to a level of detail enabling investors to carry out a comprehensive risk analysis". Furthermore, EBA recommended that the disclosure to investors currently required under Article 129(7) of the CRR should "occur at least on a quarterly basis"

As described in the EBA Report, private-led initiatives have attempted to fill this regulatory loophole with detailed investor reporting templates. Both the International Capital Markets Association's ("**ICMA**") Reporting Template and ECBC's National Transparency Templates constitute very positive initiatives insofar as they provide investors with more granular and better-suited information on covered bond programmes' liabilities and cover assets. However, having analysed the latter the EBA noted a number of challenges, for instance:

- the National Transparency Templates differ substantially across jurisdictions, partly due to the factors identified above and, notably, the lack of harmonisation between national covered bond laws;
- not all Templates seem to align with the disclosure standards set out in Article 129 of the CRR; and
- in any event, the Templates are of voluntary adoption by issuers and, accordingly, do not cover the entire market.

It is worth noting the ECBC's ongoing work to develop a "Common Harmonised Template" for all covered bond issuers holding the Covered Bond Label and which, therefore, will apply on a cross-border basis, thus potentially addressing the disparity between the National Transparency Templates. The ECBC announced that the Harmonised Template will start to apply from first quarter of 2016 with a phase-in period of one year.

QUESTIONS – TRANSPARENCY REQUIREMENTS

1. **What are your views on the current disclosure requirements set out in Article 129(7) of the CRR? If more detailed requirements were preferred, do you agree that issuers should disclose data on the credit, market and liquidity risk characteristics to a more granular level? If so, what data and to what level of granularity?**

2. **Should issuers disclose information on the counterparties involved in a covered bond programme and, if so, what type of information?**

3. **How frequently should covered bond issuers be required to make disclosures to investors?**

4. **What are your views on the existing and prospective investor reporting templates prepared by industry bodies and referred to in section 5 of Part III? Would these templates:**

    a. **be granular enough to enable investors to carry out a comprehensive risk analysis as recommended by the EBA? and**

    b. **be sufficient without further legislative backing to deliver enhanced and consistent disclosure in European covered bond markets?**

5. **Should detailed disclosure requirements apply to all European covered bonds or only to those that would fall within the scope of the Prospectus regime?**

6. **Should the same level of disclosure standards apply pre- and post-insolvency/resolution of the issuer (except for those reporting items referring to the issuer itself)?**

In relation to covered bonds issued in third countries, what minimum level of disclosure should apply for European credit institutions investing in those instruments to benefit from preferential risk weights?

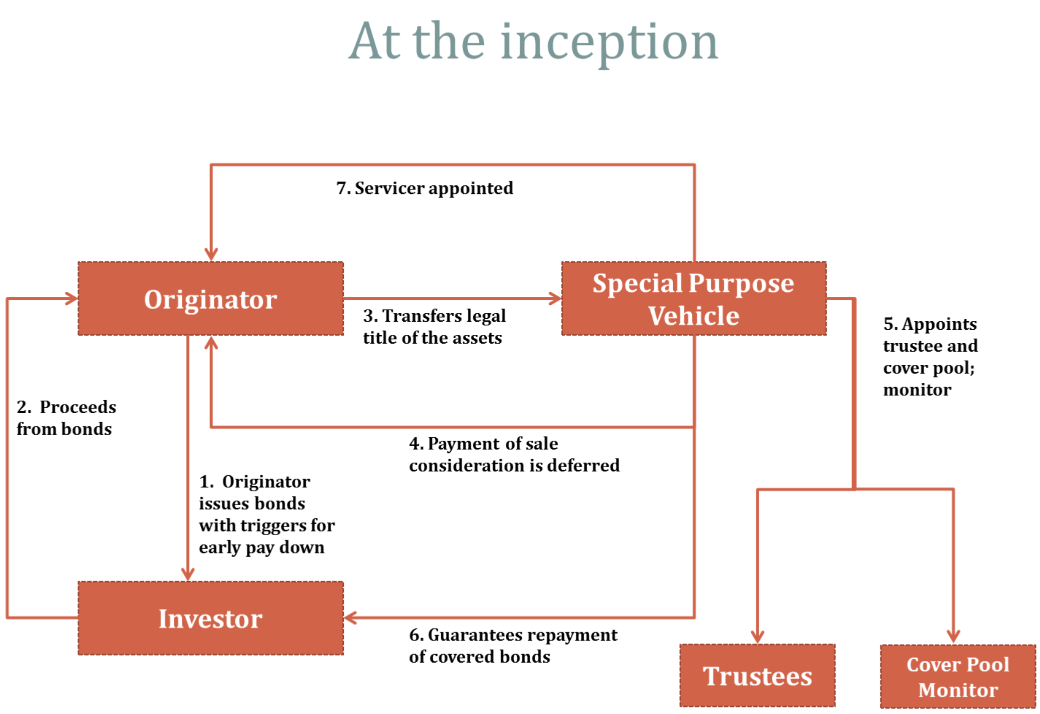
Annexure – 3

Proposed covered bonds framework in India

Structured covered bonds in India may be as follows:
At the inception of the transaction:

a. Originator will issue bonds and has the unconditional obligations to repay to the bondholders.
b. Originator makes an equitable assignment of the cover pool to an SPV. The consideration for the transfer of the receivables will be deferred over the term of the bonds.
c. The SPV stands as a guarantor to the covered bondholders. In case the issuer is unable to repay the bondholders, the SPV shall pay from the receivables forming part of the cover pool. Hence the dual recourse.
d. The SPV appoints the Originator as the servicing agent for the cover pool and also appoints a trustee and cover pool monitor to protect the interest of the bondholders in the transaction.

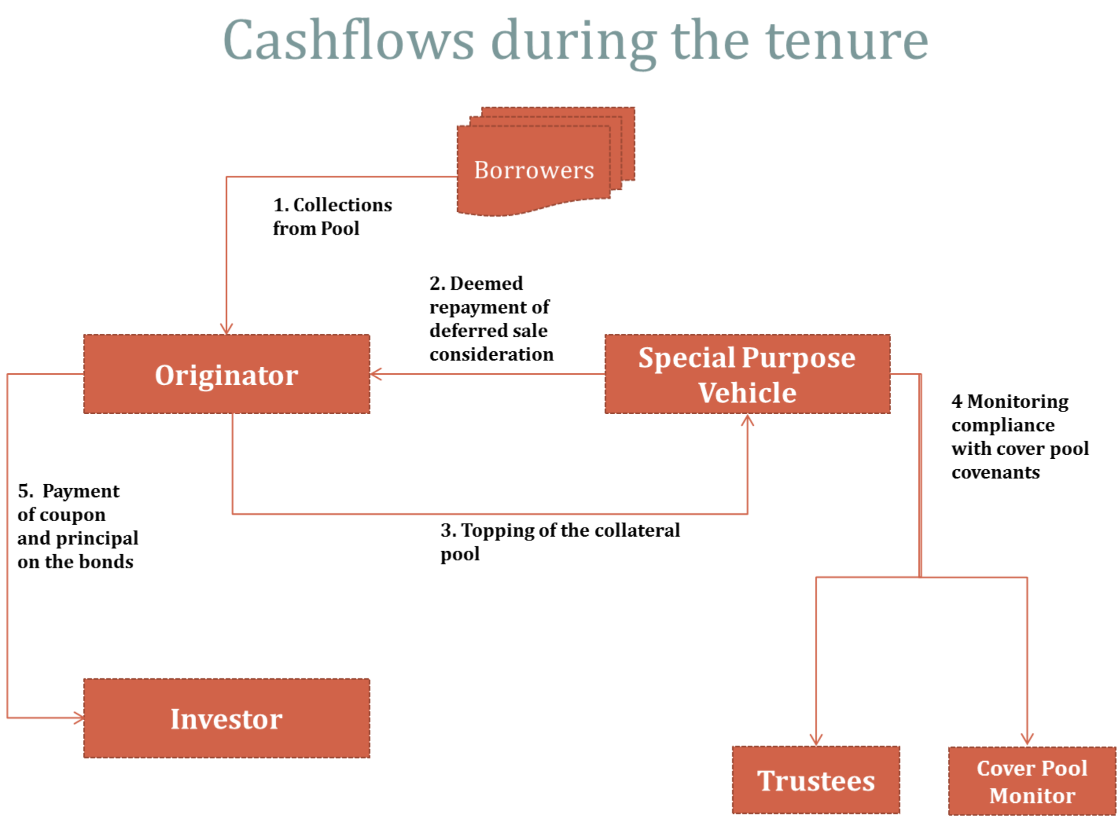
The transaction mechanics at the inception of the transaction is graphically represented as below:



During the term of the bonds:

a. During the term of the bonds, the bondholders are repaid by the Originator from its cashflows.
b. The realized receivables are used towards payment of the deferred purchase consideration by the SPV.
c. As the bonds retire, the receivables in the cover pool are used to pay the deferred purchase consideration by the SPV.

The cashflow mechanics during the term of the bonds is represented as below:



In case of default/ early amortization:

a. Where occurrence of certain events or event of default, where there is failure of the originator to repay the bonds, SPV starts to repay the bonds from the cover pool.
b. Any deferred purchase consideration payable to the Originator is stopped till the bonds retire.

The graphical presentation of the cashflow mechanics at the time of default/ early amortization are as below:

On the event of default/ happening of trigger events before the maturity