Covered Bond Framework Analysis

Analytical Considerations

www.scoperatings.com

Analysts

Karlo Fuchs

k.fuchs@scoperatings.com

Guillaume Jolivet

g.jolivet@scoperatings.com

Related research

Covered Bond Rating Methodology, July 2015

Introduction

This analysis provides Scope Ratings' (Scope) view of the credit differentiation generally merited by covered bonds above the rating of the issuing bank, excluding the positive credit support from their cover pool. Countries covered are Denmark, France, Germany, Spain and Sweden

The analysis illustrates the credit support of the legal framework and bank recovery and resolution regime incorporated into Scope's covered bond rating methodology. We analyse frameworks in the largest European countries issuing covered bonds, representing two thirds of issued covered bonds worldwide.

The main covered bond types in those countries generally achieve the maximum credit differentiation possible under our rating methodology.

Figure 1. Indicative credit differentiation per countries.

Country	Covered bond name	Primary collateral type	Legal Framework analysis	Resolution Regime analysis	Typical uplift
Denmark	Saerligt Daekkede Obligationer	Mortgages	+2	+4	+6
	Saerligt Daekkede Obligationer	Ships	+2	+2	+4
	Saerligt Daekkede Realkreditbligationer	Mortgages	+2	+4	+6
	Realobligationer	Mortgages	+2	+4	+6
France	Obligation d'habitat	Mortgages	+2	+4	+6
	Obligation foncières	Public Sector	+2	+4	+6
Germany	Öffentliche Pfandbriefe	Public Sector	+2	+4	+6
	Hypothekenpfandbriefe	Mortgages	+2	+4	+6
	Schiffspfandbriefe	Ships	+2	+2	+4
	Flugzeugpfandbriefe	Aircraft	+2	+2	+4
Spain	Cédulas Hipotecarias	Mortgages	+2	+4	+6
	Cédulas Territoriales	Public Sector	+2	+3	+5
Sweden	Säkerställda Obligationer	Mortgages	+2	+4	+6

Source: Scope

Note: Credit differentiation is expressed as a rating notch above the bank issuer rating (ICSR). The above uplift does not considering benefits provided by the covered pool

Covered bonds in the above countries are generally based on robust legal frameworks and have high systemic relevance supporting the classification. The benefit of a local legal framework and local translation of BRRD generally apply to all issuers of the same covered bond type within that country. However, different systemic importance and liability structures of a bank may produce different outcomes in the event of bail-in. Consequently, the fundamental credit differentiation between the issuer and a covered bond rating may slightly deviate among issuers in the same country.

Covered bonds used to finance assets important for the economy and used by the majority of banks in the country generally merit the maximum possible credit uplift.

Lower systemic importance of other domestic covered bond types generally produces a smaller differentiation to the bank rating. Strong and predictable support might be less likely in the event of regulatory action on the issuer, as such covered bond's credit impairment is unlikely to have wider impact on the domestic economy or financial system.

Scope Ratings AG

Lennéstraße 5
D-10785 Berlin
T: +49-30-27891-0
F: +49-30-27891-100
Service: +49-30-27891-300

info@scoperatings.com
www.scoperatings.com

Legal framework and resolution regime assessment

Table of Contents

Legal framework and resolution regime assessment 2
Fundamental analysis per country 3
Denmark 4
France 8
Germany 11
Spain 14
Sweden 17
Disclaimer 20

The legal framework analysis in our methodology covers aspects relevant upon the insolvency of the issuer. The analysis aims to clarify the availability of the cover pool when it is the sole source of repayment for a covered bond.

We ascertain how the structure interacts with other provisions such as relevant banking acts, general insolvency laws as well as other related topics such as consumer protection.

The resolution regime analysis generally addresses the situation prior, and up to issuer insolvency. When analysing the Bank Recovery and Resolution Directive (BRRD) or similar resolution regimes, we focus on the ability of statutory provisions to maintain the dual recourse nature of the covered bond (i.e. by bail-in and/or restructuring the covered bond issuer). We form a view on the likelihood regulators, supervisors or the private sector will be actively supportive in avoiding uncertainty for covered bonds and ensuring their continuity as a funding instrument.

The following summarises the main characteristics we consider relevant to assess the fundamental credit differentiation of the covered bond above the issuer rating. For more details, see our *Covered Bond Rating Methodology*.

Legal framework assessment

In the legal framework assessment, we determine whether a smooth transition of the covered bond structure away from the insolvent issuer is possible. In general, the transition allows for maintenance of the cover pool and for ongoing full and timely payment of outstanding covered bonds upon restructuring or insolvency. Under supportive covered bond jurisdictions, programme enhancements, in particular overcollateralisation, remain available, valid and enforceable to other creditors. Neither a regulatory action nor an issuer default event impacts the ability to manage the covered bond structure in the best interests of investors. The legal framework generally provides for credit, market and liquidity risk management prior to insolvency and allows proactive liquidity management after insolvency to facilitate timely payment to covered bond holders. We seek to understand how a potential conflict of interest between covered bond and other stakeholders is resolved in a regulatory action or insolvency. Lastly, we analyse whether the supervisor or a special trustee provide independent and regular oversight of the programme structure, such as asset composition/ structural risk.

If the elements above only partially apply, the robustness of the covered bond is negatively affected and credit differentiation will be limited. For instance, if covered bonds were to accelerate upon insolvency of the issuer, either because of contractual or statutory provisions, the maximum uplift from the legal framework analysis for the covered bond rating will warrant only a limited uplift, possibly just one notch. Similarly, the absence of a dedicated covered bond oversight will likely prevent it receiving the highest credit differentiation. The limitation reflects that some of the main assumptions for a standard covered bond are not met; i.e. uninterrupted payment of bonds after insolvency or special oversight.

Regulatory definitions of covered bonds address some aspects relevant for the rating analysis. Scope´s assessment of the legal framework does not follow regulatory designations mechanistically, but focuses on aspects relevant to the credit characteristics of the instrument.

Resolution regime analysis

We believe that for covered bonds issued by banks operating subject to BRRD or similar resolution regimes, recourse events to the cover pool will become extremely unlikely compared to pre-resolution regime times.

While in practice, pan-European implementation of the BRRD will introduce a level playing field for all European covered bonds from a legal perspective, we believe that clarity, predictability and scope of application can differ between European countries.

When determining the credit differentiation between covered bonds and the bank's ICSR driven by the resolution regime, we identify factors that tell us if a regulatory intervention on the issuer will impact a covered bond's credit quality and impair its ongoing performance, for example whether:

- statutory provisions in resolution regimes address the going concern status of covered bonds upon a regulatory intervention on the issuer;

- the issuer's liability structure, or level of bail-in-able debt provides sufficient room for regulators to use available resolution tools to restructure the issuer to maintain the covered bond program as a going concern. We consider whether the level of bail-in-able debt provides sufficient loss-absorption to protect covered bonds;
- covered bonds are a systemically important funding tool used by the majority of banks in the country;
- this specific covered bond type is the main tool to refinance a specific asset type that has macroeconomic importance for the country and whether it has a significant share of domestic investors; and
- there is an active domestic stakeholder community (regulators, issuers and investors) proactively monitoring market developments and maintaining confidence in the product and encouraging improvement of relevant regulations. We assess the clarity and predictability of statutory provisions and their interpretation and the track record of the authorities.

We believe these aspects are important to understand the ability to maintain covered bonds as a going concern funding instrument – even during a resolution process. If we believe regulatory action regarding the issuer is unlikely to impact a covered bond as a going concern instrument, we translate this reduced likelihood of default by assigning up to four notches uplift for the availability of a supportive resolution framework.

If elements from the above apply only partially, benefits of the resolution regime will be limited, reflecting the increased likelihood of the covered bonds winding down and the cover pool becoming the sole source of repayment for the covered bonds.

Fundamental analysis per country

The analysis below reflects our current understanding of each country and specific legal frameworks governing the issuance of various covered bond types. It also reflects the assessment of available formal resolution measures and our view on how the systemic relevance of the specific covered bond product is likely to mobilise resolution authorities to preserve this refinancing channel for domestic banks. The results highlighted in this report may not automatically apply to individual covered bonds, because certain issuer specific factors also affect the fundamental analysis in our methodology. The regulatory environment is likely to remain fluid and thus conclusions presented need regular updates to reflect latest developments.

Covered bond frameworks in Europe receive close attention from regulators and maintenance of current preferential risk weights will likely prompt further changes to existing frameworks. In July 2014 the European Banking Authority (EBA) published an analysis of existing covered bond frameworks and issued a best practice guideline[1] highlighting common features legal frameworks should address to allow preferential treatment under Basle III. As the European Commission will likely further encourage harmonisation, we expect legal frameworks to adjust – further modifying our current conclusions.

Similarly, most European countries have already fully implemented BRRD. Some still need to translate the resolution framework into national law[2]. Transition should be completed by the end of the year, but domestic interpretation and interaction with local insolvency frameworks is likely to remain dynamic. Lastly, covered bond related provisions or guidance is limited in the directive. Resolution authorities need to coordinate with individual covered bond supervisors highlighting the need to reflect incentives to preserve the functioning of the domestic covered bond market.

[1] Opinion of the European Banking Authority on the preferential capital treatment of covered bonds, published 1. July 2014
[2] On 28th May 2015, the European Commission has requested Bulgaria, the Czech Republic, France, Italy, Lithuania, Luxembourg, the Netherlands, Malta, Poland, Romania and Sweden to fully implement the BRRD into their national law within the next two months.

Denmark

Covered bond type

Saerligt Daekkede Obligationer (SDO - Mortgage Covered Bonds)

Saerligt Daekkede Realkreditbligationer (SDRO - Mortgage Covered Bonds)

Realobligationer (RO - Mortgage Covered Bonds)

Skibskreditobligationer (RO's or SDO's backed by Ships

Indicative fundamental credit differentiation

Mortgage covered bonds enjoy a higher fundamental strength than ship

Covered bond name	Primary collateral type	Legal Framework analysis	Resolution Regime analysis
Saerligt Daekkede Obligationer	Mortgages	+2	+4
Saerligt Daekkede Obligationer	Ships	+2	+2
Saerligt Daekkede Realkreditbligationer	Mortgages	+2	+4
Realobligationer	Mortgages	+2	+4

Legal framework assessment

Two notches for all covered bonds

Danish mortgage covered bonds are among the oldest covered bonds and first legal frameworks date back to the 1850s. Since then there have been several amendments to the covered bond acts, but its core elements, in particular the unique 'balance principle', remain. The amendments have traditionally reflected the changing domestic banking or regulatory landscape. This holds true for the latest major amendment[3] in 2007, which liberalised covered bond issuance to include universal banks, who since can now also issue SDRO's. Before this amendment, covered bond issuance was confined to specialist mortgage banks. Although most technical provisions on covered bonds were maintained, the 2007 amendment introduced new elements from a CRR perspective. In particular the regular revaluation requirement for cover assets stipulated in article 129 (3) is the main differentiating factor between RO's (with no regular assets revaluation requirement according to the act) and the dynamic revaluation and potential 'top-up' requirements applicable for SDO's and SDROs. The most recent amendment adopted in 2014, addressed refinancing risk for short dated covered bonds. The amendment introduced a statutory extension of one year in case refinancing is not possible or only at significantly higher rates of over 5% or more. There are no material deviations with regards to rating relevant provisions for mortgage or ship covered bonds in the act.

Segregation of cover pool upon insolvency

The Danish cover bond framework allows for multiple covered bond types (as above) and also allows an issuer to have multiple, independent cover pools, or capital centres. Each capital centre only supports one dedicated set of covered bonds related to that capital centre. Covered bonds have a preferential status upon insolvency and investors have recourse to the cover assets of their respective centre. Each capital centre is segregated from the general insolvency estate. Danish covered bonds do not accelerate upon issuer insolvency.

Ability to continue payments after issuer insolvency

Upon insolvency, a special administrator is appointed by the Danish FSA (Finanstilsynet) and the administrator manages and monitors the covered bond estates with a mandate to ensure timely payments. The law specifies that neither a moratorium nor the insolvency of the issuer impacts the ability to make timely payments and the capital centre concept allows for a clear segregation of cover assets and related cash flows upon insolvency of the issuer.

[3] Act no 577 of 1 July 2007amending the Danish Financial Business Act

Programme enhancements remain available

RO's and SDRO's have a mandatory overcollateralisation requirement of 8% of risk weighted assets. Issuers need to ensure a net present value (NPV) coverage. There is no legal minimum overcollateralisation for universal banks issuing SDO`s. Typically, SDO's benefit from a committed overcollateralisation similar to other program enhancements (e.g. derivatives registered in the capital centre) that remain available after the insolvency.

Liquidity and other risk management guidelines

Generally RO's and SDRO's are managed according to the "specific balancing principle" which provides for bonds to be issued at the same terms as the underlying mortgage loans. In itself this principle almost fully eliminates market and liquidity risk RO´s and SDRO´s therefore do typically not include derivatives. By contrast, derivatives are often used for SDO's as compared to SDROs, the "general balance principle" offers less matched structures. Risk management requirements for Danish covered bonds are some of the strictest in Europe addressing interest rate, currency and option risk, tying the maximum value deviations of the cover pool to a dedicated share of overcollateralisation. Each capital centre is monitored independently and has to comply individually with the respective regulations.

Liquidity risk for Danish covered bonds is very low due to the requirement to match asset redemptions with covered bond redemptions due. It is further facilitated by the ability to use substitute assets (which are also introduced to capital centres to efficiently manage the regulatory overcollateralisation requirements).

Covered bond oversight

Issuance and maintenance of the covered bond programs is supervised by the Danish Financial Services Authority DFSA. An independent auditor inspects the cover pool biannually and notifies the DFSA about its findings.

Other legal framework considerations

Although SDO's and SDRO's are UCITS and CRR compliant, due to the missing regular revaluation requirements, covered bonds issued as RO's are not CRR compliant[4]. The potential level of overcollateralisation needed to mitigate risks in RO's can, ceteris paribus, be higher than for SDO's or SDRO's. This is because in times of negative house price development a mortgage with the same "LTV" in the respective covered bonds will result in lower recoveries than in the case of ROs, as potential overvaluations are not adjusted via indexation. In the legal framework assessment we do not sanction the missing CRR designation of ROs, as the different valuation requirements are already reflected in the cover pool analysis.

Rating relevant aspects of the EBA's best practice guidelines are already available, supporting our view that the full benefit of the legal framework analysis can be applied to all covered bond types. The rating relevant provisions of the legal framework do not differentiate materially between covered bond types.

Resolution regime assessment:

Generally four notches for mortgage and two for ship covered bonds

Translation of BRRD into national law

Denmark implemented the EU's Bank Recovery and Resolution Directive (BRRD) in June 2015, including the in-ability to bail-in covered bonds, in national law. We understand there is no distinction between mortgage and ship covered bonds.

Denmark already has a track record using the bail-in tool during and after the financial crisis for small- and medium-sized credit institutions. We observe some slight deviations of the translation of the BRRD into national law. Supervisors, regulators, other mortgage and covered bond market stakeholders have been highly active ensuring the BRRD does not negatively impact the functioning of the current mortgage finance system. This led to the provision that mortgage banks (realkreditinstitut) and not only their covered bonds, are expected to operate as a going concern even in case of distress. Danish mortgage banks do not typically have deposits or significant amounts of unsecured debt. They therefore will become subject to a MREL equivalent requirement. Until 2024 they need to build up an additional capital buffer of 2% (of unweighted loans) to ensure business continuation in the event of a regulatory intervention and avoid insolvency. This aims to facilitate a business

[4] RO's issued before 31. December 2007 are grandfathered and thus remain CRR compliant; RO's issued thereafter do not qualify as CRR compliant bonds

continuation rather than using other resolution options (divestment; continuation using a "bridge bank" or orderly wind down).

Systemic relevance of covered bonds in Denmark

Covered bonds have high systemic relevance for Denmark where outstanding covered bonds represent 147% of Danish GDP as of January 2015, the highest share worldwide. Danish government debt makes up only 45% of GDP and regulators are conscious of the high systemic importance of Danish mortgage banks, whose domestic covered bonds account for the largest share of tradable debt in Danish debt capital markets.

Systemic relevance of mortgage covered bonds

Mortgage covered bonds, regardless whether issued as RO's or SDO's or SDRO's, are the most important refinancing instrument for mortgages in Denmark, and funding residential mortgage loans on an unsecured basis remains limited. From a domestic investors perspective, mortgage covered bonds have a central role as they are not exposing investors to foreign exchange risk. Almost 80% (as of June 2014) of covered bonds are held domestically and only a small fraction by foreign investors. The strong domestic involvement in our view supported the ongoing functioning during the crisis. We observed ongoing issuance and trading at times where other covered bond markets hibernated or were closed. This highlights the strong support and the high systemic importance of the mortgage covered bond product in the domestic context.

Systemic relevance of ship covered bonds

In contrast to mortgage covered bonds which are issued by the majority of Danish banks, issuance of ship covered bonds rests with only one issuer. Issuance and the amount of outstanding ship covered bonds are therefore strongly aligned with the business activities of this issuer. With current outstanding of EUR 5bn ship covered bonds and yearly issuance of EUR 400mn we believe that in both the Danish and international context this covered bond type has less importance.

Proactive stakeholder community

We expect the systemic importance of mortgage covered bond funding in Denmark to remain high for the foreseeable future and for regulators and other stakeholders to remain supportive and active. Discussions surrounding the entry into the capital market union, the impact of European supervision for Danish banks, as well as the application of MREL for mortgage banks has again crystallised the importance of mortgage covered bond issuers and mortgage financing for the Danish economy.

We generally apply the maximum credit differentiation of four notches for resolution based support to Danish mortgage covered bonds

As a niche product we do not expect a similar strong level of stakeholder support for ship covered bonds. This is in our view also evidenced by the 2014 derogation of ship covered bonds as eligible assets by the Danish central bank. The status of ship covered bonds in a country with a high covered bond intensity still allows for additional credit differentiation of two notches, however.

Key Covered bond Framework characteristics: Denmark

Issuer	Universal bank with special covered bond issuance license (SDO) Specialised mortgage bank (RO, SDRO)
Cover assets	Mortgage assets (residential, commercial and agricultural assets; no restriction on respective shares) Exposures to public sector entities Substitute assets (max 15% of the cover pool) exposures to public sector, banks; cover assets can be domiciled within the EEA and certain OECD countries SDO: Special register constitutes the cover pool; RO/ SDRO: Capital centre concept – several dedicated cover pools provide collateral for designated issuances

Loan to value restrictions	Residential mortgage assets max 80% LTV (75% LTV for other, nonstandard mortgages and 60% LTV for secondary residences) Valuation: SDO/ SDRO: regularly indexed valuations; RO: original valuations Commercial and agricultural assets max. 60% (up to 70% if additional security is provided - valuation as per above) Covered bond investors have a preferential claim on the cover assets – also on recovery proceeds in case the mortgage loan exceeds the LTV; SDO/ SDRO: if LTV exceeds threshold, issuer is required to remedy missing coverage with the inclusion of substitute cover assets.
Market and liquidity risk guidelines	Special and general coverage principle stipulates stringent guidelines on the management of interest, foreign exchange as well as liquidity risks
Coverage principle/ Minimum oc	Based on daily net present value calculations: 8% of risk weighted assets (specialist banks)/ No minimum oc for SDO's but voluntary overcollateralisation commitments are provided that are protected
Treatment upon insolvency	Insolvency of the issuer does not impact the ability to make uninterrupted payments on the covered bonds; No acceleration upon insolvency.
Mandatory Transparency	Yes
UCITS/ CRR compliance	RO: Yes/ issued before 2008 grandfathered; SDO/ SDRO: Yes/ Yes
Special supervision	Finanstilsynet – the Danish banking regulator; independent auditor inspects the cover pool and reports to the Danish regulator twice a year; no other independent trustee.

France

Covered bond type

Obligation Foncieres (OF) –backed by public sector or mortgage collateral

Obilgations de Financement de l'Habitat (OH) - mortgage covered bonds

Combined framework assessment

Both covered bond types receive the same uplift

Covered bond name	Primary collateral type	Legal Framework analysis	Resolution Regime analysis
Obligation d'habitat	Mortgages	+2	+4
Obligation foncières	Public Sector	+2	+4

Legal framework assessment

Eligible for two notches

Like Denmark and Germany, French covered bonds are among the oldest covered bond types in Europe (OF date back to 1852). The main provisions of the legal covered bond framework for OF are provided by the French Monetary and Financial Code, Articles L.515-13 to L.515-33, State Council Decree No. 99-710 and French Banking and Financial Regulatory Committee (CRBF) Regulation n°99-10 (dated 1999) last amendment on 23 February 2011; the OH framework is based on the French Monetary and Financial Code, Articles L.515-15 to L.515-39, Decree No. 2011-205 of 23 February 2011

The framework has been updated regularly reflecting the ongoing dialogue between domestic issuers, investors and regulators/ supervisors. For example, due to specifics of the French mortgage market, banks were unable to refinance standard mortgage loans with Obligation Foncieres due to the respective cover assets eligibility definitions (Note: French mortgage loans are typically not directly secured with a mortgage, but with a guarantee). French banks therefore began issuing "structured covered bonds" outside the established OF framework, but which failed to meet the UCITS definition. After this competitive disadvantage was identified, a new covered bond type was introduced: Obilgations de Financement de l'Habitat (OH). Both frameworks are now strongly aligned.

Segregation of cover pool upon insolvency

Both, OF and OH have a preferential claim on the respective assets (including overcollateralisation) of the covered bond issuer. The issuer is a specialist financial institution supervised by the French regulator (Autorité de Contrôle Prudentiel). For OF the issuer is a Société de Crédit Foncier or SCF; for OH the issuer is a Sociétés de Financement de l'Habitat – or SFH. Investors in OF or OH have no direct recourse to the parent of the issuer but only to the specialist issuer.

Generally the assets are originated and remain serviced by the parent bank whose insolvency does not generally impact the validity of the legal transfer of the asset into the SCF or the SFH even though in some structures the cover assets can remain on the balance sheet of the issuer and the issuer (typically in case of an SFH) has only a "secured claim". Any other claims of the SCF or SFH are subordinated to "privileged", in particular covered bond creditors. Due to the limitations of the issuer's business activities and the special legal setup of the issuer they are almost insolvency remote as upon insolvency other creditors will only receive payments if covered bonds are paid in full. Even in the remote case of issuer default, covered bonds do not accelerate (SCF: Art. L515-19; SFH are typically insolvency remote).

Ability to continue to make payments after issuer insolvency

The respective laws do not foresee the issuer's insolvency impacting its ability to make timely payments on their covered bonds. The acts stipulate a maximum mismatch between cover assets and covered bonds. Further liquidity provisions such as the mandatory liquidity buffer that covers shortfalls within the next 180 days are available. Depending on the covered bond type, additional mechanisms can be contracted by the issuer (prematurity test and/or soft-bullets). Both issuer types can enter into repo financings to cover temporary liquidity shortfalls.

Remain programme enhancements available

Derivative counterparties rank pari passu with covered bonds and will not accelerate upon the issuer's insolvency; As all other creditors of the SCF or SFH rank junior to covered bonds, available oc on the balance sheet remains fully available for covered bond holders upon insolvency of the issuer (or the parent) and must be at least 5% above the level of outstanding covered bonds.

Liquidity and other risk management guidelines

Both frameworks have explicit guidelines that contain liquidity risk in the structure. As regulated entities, the issuers have to maintain an active market risk management to comply with regulatory requirements. As a specialist bank the restrictions implicitly benefit the covered bonds. Market risks for French covered bond issuers are to a very significant extent reduced by derivatives and the trustees are obliged to monitor the ongoing adequacy of risk management.

Covered bond oversight

In addition to general banking supervision by the French banking regulator, several additional external monitoring requirements exist. For OF; an independent trustee (Contrôleur Spécifique) and for OH, an independent asset monitor supervises statutory or contractual maintenance requirements. Failures to comply must be referred to the regulator. Trustees are liable for any misconduct and are independent of both the issuer and sponsor bank.

Other legal framework considerations

Generally, all French covered bonds are fully UCITS compliant and most covered bond types also comply with the provisions of the CRR.

Based on our analysis we do not see any rating-relevant differences between the two covered bond legislations and will generally provide them with the full credit differentiation of two notches.

Resolution regime assessment

Generally eligible for four notches

Translation of BRRD into national law

France has not yet fully translated the BRRD into national law and the European Commission has warned France that full translation of the BRRD remains outstanding (see above). Nonetheless, a resolution regime that is in line with the overall principles and objectives is in our view already in place (law 2013-672 of July 26 2013). We understand that one of the major differences to the BRRD is that senior unsecured debt is not (yet) bail-in-able. This also applies to higher ranking senior secured covered bond debt. We do not expect that the fully compliant BRRD implementation will introduce any negative provisions for French covered bonds and preserve their status as being nonbail-in-able.

Systemic relevance of covered bonds in France

The share of outstanding French covered bonds as well as annual new issuance typically ranks among the top five worldwide (EUR 325bn outstanding vs. annual issuance of EUR 26bn in 2014). French covered bonds are used by all major banking groups and the share of covered bonds compared to the GDP stood at 15% at the end of 2014.

Systemic relevance of mortgage and public sector covered bonds

French covered bond issuance volumes are far larger than corresponding ABS issuance for the respective asset type, reflecting the importance of covered bonds for refinancing mortgage or public sector lending in France. The market has a strong footprint with both international as well as domestic investors.

Proactive stakeholder community

France has not seen any covered bond defaults to date. Support for covered bond issuers in distress was in evidence when one of the largest providers for domestic public sector lending, as well as one of the largest covered bond issuers worldwide (Dexia Group) was bailed out. We believe that stakeholders will ensure that the formal translation of the BRRD will not impact the importance of covered bond funding and that together there is a strong alignment of interests to maintain covered bonds as a going

concern – even when the issuer is subject to regulatory intervention. The systemic importance of covered bond funding in France is expected to remain high. In our view stakeholders are highly incentivised to support the product.
We believe the high systemic importance will incentivise regulators to use the resolution framework without impairing the functioning of covered bonds and generally will allow a credit differentiation of four notches for the benefits of the resolution regime.

Key Covered bond Framework characteristics: France

Issuer	Only specialised credit institutions (SCF; SFH) can issue covered bonds
Cover assets	First-ranking residential or commercial (OF only) mortgage loans; State-guaranteed real-estate loans. Third-party guaranteed real estate loans (limited depending on strength of the guarantee provider) In theory mortgage loans within the European Economic Area are eligible, but in practice only domestic loans are present in cover pools. Public sector loans, bonds or debt covered by public guarantees from entities within EEA and outside EEA based on rating requirements (OF only). MBS or ABS provided a look through allows for maintenance of asset eligibility requirements (with limitations). No separation of public and mortgage cover asset pools required. Max. 15% Substitution assets comprising cash, bank and public sector exposures. Derivatives
Loan to value restrictions	Residential mortgage assets (both) max 80% LTV; commercial mortgage loans (OF) max 60% LTV. Valuation: market values (OH); Mortgage lending value (OF); loans over 90 days overdue must be removed from the cover pool (OF); do not count at full face value for the mandatory tests (OH); large mortgage loans have to be revalued on an annual basis and generally ever three years. Covered bond investors have a preferential claim on covered assets and on recovery proceeds in case the mortgage loan exceeds the LTV
Market and liquidity risk guidelines	General risk management requirements applicable to banks; minimum 180 day liquidity coverage or alternative mitigants (e.g. soft bullet); remaining weighted average life (WAL) of the cover assets shall not exceed the WAL of the covered bonds by more than 18 months
Coverage principle/Minimum oc	5% minimum overcollateralisation; certain intragroup exposures do not fully qualify for the overcollateralisation calculation
Treatment upon insolvency	Provisions to facilitate uninterrupted payments on the covered bonds and low incentives for external creditors to file for insolvency; no acceleration upon insolvency
Mandatory Transparency	Yes
UCITS/ CRR compliance	Yes/ Yes
Special supervision	Autorité de Contrôle Prudentiel providing banking supervision of the specialist credit institution independent trustee (Contrôleur Spécifique) and for OH, an independent asset monitor monitoring the statutory or contractual maintenance requirements

Germany

Covered bond type

Hypothekenpfandbriefe (Mortgage Covered Bonds)

Öffentliche Pfandbriefe (Public Sector covered bonds)

Schiffspfandbriefe (Ship covered bonds)

Flugzeugpfandbriefe (aircraft covered bonds)

Combined framework assessment

Mortgage covered bonds eligible for six notches; ship and aircraft only four

Covered bond name	Primary collateral type	Legal Framework analysis	Resolution Regime analysis
Öffentliche Pfandbriefe	Public Sector	+2	+4
Hypothekenpfandbriefe	Mortgages	+2	+4
Schiffspfandbriefe	Ships	+2	+2
Flugzeugpfandbriefe	Aircraft	+2	+2

Legal framework assessment

Two notches support for all specific legislation based covered bond types

German covered bonds were the first covered bonds and its origins date back to 1769. The German covered bond framework is among the most comprehensive and most regularly updated. Basic principles are maintained and amendments usually introduce further clarifications and – where necessary – additional provisions for the benefit of investors. The German covered bond legislation (Pfandbriefgesetz) was the first to acknowledge liquidity risk for hard bullet covered bonds and introduced a mandatory liquidity coverage requirement (180-day liquidity coverage requirement) to mitigate this risk. Further, the latest amendment clarified the legal status of the cover pool in case a cover pool manager wants to enter into repo operations, e.g. with central banks after the insolvency of the issuer.

We note that German covered bond legislation is among the most comprehensive specific legislations in the world. The framework also provides for further supplementary regulations establishing transparent and harmonised rules on how a prudently assessed loan-to-value ratio must be established or how on a consistent basis market risk stress tests have to be conducted on a consistent basis. (Regulation on the Determination of the Mortgage Lending Value as well as the Net present value regulation).

Segregation of the cover pool upon insolvency

Covered bonds benefit from a preferential claim on all assets registered in the cover pool and additions and deletions of cover assets are supervised and only valid upon approval of the trustee. Before the insolvency of the issuer, regulators can already appoint a special trustee (Sachwalter) which takes over the management of the cover pool. Upon the issuers insolvency the cover pool – which comprises all registered eligible assets and related covered bonds - is separated from the issuers general insolvency estate and managed with a view to allow full and timely payment. The issuer’s insolvency does not trigger an acceleration of covered bonds compared to other debt of the issuer.

Ability to make payments after issuer insolvency

The covered bond act addresses the ability to continue ongoing payment of covered bonds after the insolvency of the issuer. The covered bonds have priority rights on cash flows received on assets registered in the cover pool. With the legal 180 day liquidity requirement - which requires that sufficient amounts of highly liquid assets are maintained in the cover pool to cover shortfalls in that period –additional means are also provided. Further, as the cover pool entity maintains a special banking status, the cover bonds can also benefit from the ability to manage liquidity by tapping into central bank repo operations.

Remain program enhancements available

German covered bonds benefit from a minimum overcollateralisation of 2% based on a net present value (NPV) - after applying market risk stresses according to the act. Effectively,

the NPV regulations also introduce market risk limits. In contrast to other jurisdictions, market risk is managed by matching the risks rather than employing derivatives to reduce the risks. In case derivatives are registered in the cover pool, they will not accelerate in line with other obligations of the issuer.

Covered bond oversight

Regulators actively monitor the various covered bond specific risk management and valuation obligations stipulated in the act and perform regular onsite inspections. The independent trustee acts as a gatekeeper for the cover pool checking eligibility requirements prior to registration, approving new issuances and monitoring risk management obligations of the issuer. Upon insolvency a special trustee takes over the management of the program.

Other legal framework considerations

All German covered bonds are fully UCITS compliant and most covered bond types also comply with the provisions of the CRR (except for aircraft covered bonds as the asset type is not listed as an eligible asset within the article 129 of the CRR).

There are no rating relevant aspects that materially differ between covered bond types and that are relevant for the assessment of the legal framework differentiation. Generally, all German covered bonds types receive the full rating uplift for the supportive legal framework

Resolution regime assessment

Main covered bond types four notches; ship and aircraft only two notches

Translation of BRRD into national law

Germany has been among the first countries to fully implement the BRRD including the bail-in tool into national law (BRRD-Umsetzungsgesetz). The law is fully in line with the European Commission's Directive (2014/59/EU) and excludes Pfandbriefe from becoming bailed-in upon a regulatory intervention.

Systemic relevance of covered bonds in Germany

The share of outstanding German covered bonds ranks among the highest worldwide and Pfandbriefe are used by the majority of larger and midsized banks (78 banks have a license to issue covered bonds). Based on available data, public sector loans and (in particular commercial) mortgages are a very significant wholesale refinancing instrument for the issuers. The combined outstanding covered bonds as share of GDP stood at 14% at the end of 2014

Systemic relevance of mortgage and public sector covered bonds

The amount of outstanding German covered bonds shrunk significantly over the last years and more than halved from over EUR 1trn in 2004 to just about EUR 402bn in 2014. In our view they are an integral feature in the domestic capital debt markets and vital for the refinancing of commercial and public sector loans. German investors and in particular insurance companies, have among the largest holdings in covered bonds worldwide, highlighting the importance of a well-functioning covered bond market for both domestic issuers and investors.

Systemic relevance of ship and aircraft covered bonds

German banks have traditionally been among the largest ship and aircraft financers worldwide; while secured financing is important for the asset class, refinancing via covered bonds has only played a marginal role. Specialist banks active in that area have to date only made occasional use of the product, also reflecting the high operational requirements for ongoing maintenance of the programs. With only four issuers actively using ship covered bonds and only one issuer for aircraft covered bonds, the systemic importance of the products is very modest and does not merit in our view a specific benefit for this criteria. Outstanding ship covered bonds at the end of 2014 were EUR 4.8bn and only EUR 1bn of aircraft covered bonds were outstanding. Combined issuance in 2014 was EUR 1.4bn, but issuance patterns reflect their irregular use.

Proactive stakeholder community

German stakeholders have demonstrated regularly they are strongly interested in a functioning covered bond market and are willing to support an orderly resolution of problems in case of a distressed issuer. Even before the BRRD came into force, such

issuers were often resolved by means other than insolvency. We observed several market-led resolutions with distressed issuers becoming merged, sold to other banks or that market stakeholders have remained supportive to allow an orderly wind-down of the cover pool. This is despite strong and robust provisions that deal with issuer insolvency.

We are less certain that stakeholder support would be as strong for ship or aircraft covered bonds and support rather be driven by issuer-related considerations. We do not expect an additional dedicated credit differentiation for stakeholder support to be warranted. The general benefits from the formal resolution regime and its "covered bond" status in the domestic context sufficiently reflects the benefits of the refinancing instrument. We expect systemic importance of covered bond funding to remain high in Germany for the foreseeable future and the implementation of the BRRD formalising existing practices rather than introducing new benefits.

Based on the above considerations our assessment will allow us to provide German public and mortgage covered bonds with the full resolution based uplift. The limited use of ship and aircraft covered bonds in our view only warrants a credit differentiation of two notches.

Key Covered bond Framework characteristics: Germany

Issuer	Regulated banks with a specific license to issue covered bonds (covered bond type specific)
Cover assets	Residential and Commercial mortgage loans within the EEA, Japan, Switzerland and the United States (non EEA exposures with certain limitations). Public sector loans and bonds within the EEA, Japan, Switzerland and the United States (non EEA exposures with certain limitations) Ships (completed and under construction) provided they are recorded in a public German ship mortgage registry and comply with specific provisions for ship cover assets Aircraft loans provided they are registered and comply with specific legal requirements Substitution or other assets: up to 10% of the outstanding covered bonds (20% for mortgage covered bonds) comprising public sector exposures as per the covered bond act, banks exposures as well as derivative agreements.
Loan to value restrictions	Residential and commercial assets max. 60% MLTV Valuation: specific regulations for the determination of a prudently assessed mortgage lending value (separate for Mortgages, Aircraft and ships) typically about 10% below market value at origination Covered bond investors have a preferential claim covered assets – also on recovery proceeds in case the mortgage loan exceeds the LTV
Market and Liquidity risk guidelines	Net present value regulation provides specific set of covered bond specific market risk tests; minimum 180 day liquidity coverage or alternative mitigants
Coverage principle/ Minimum oc	Nominal matching requirement; minimum 2% NPV coverage after applying market risk stresses; overcollateralisation available upon insolvency remains protected
Treatment upon insolvency	Provisions to facilitate uninterrupted payments on the covered bonds; no acceleration upon insolvency
Mandatory Transparency	Yes – directly stipulated in the act and applicable for all issuers (§28 PfandBG)
UCITS/ CRR compliance	Mortgage/ Public sector/ Ship: Yes/ Yes; Aircraft: Yes/ No
Special supervision	BaFin – the German banking regulator; independent and personal liable trustee; special trustee as cover pool manager, appointed upon or before issuer default

Spain

Covered bond type

Cédulas Hipotecarias (CH - mortgage covered bonds)

Cédulas Territoriales (CT – public sector covered bonds)[5]

Combined framework assessment

Mortgage covered bonds eligible for six notches; public sector five

Covered bond name	Primary collateral type	Legal Framework analysis	Resolution Regime analysis
Cédulas Hipotecarias	Mortgages	+2	+4
Cédulas Territoriales	Public Sector	+2	+3

Legal framework assessment

Eligible for two notches uplift

Segregation of the cover pool upon insolvency

The current Spanish covered bond framework builds on several individual acts[6] that provide for the legal basis for the issuance of covered bonds and their insolvency remoteness. The Spanish covered bond framework does not anticipate a segregation of the cover pool upon insolvency. Rather CH's have a preferential right on the proceeds of the full mortgage book (not only the registered cover assets) and CT's to the full public sector book of the insolvent issuer.

Ability to continue to make payments after issuer insolvency

In addition the preferential right on the cash flows of the whole mortgage book, the law allows for registration of substitute assets – which none of the issuers has made use of so far. There is no acceleration of the covered bonds upon insolvency of the issuer.

Remain programme enhancements available

Both CH's and CT's benefit from a generous mandatory overcollateralisation of 25% and 43% respectively. Effectively, the available overcollateralisation is much larger as the eligible book only provides for an issuance limit and covered bonds have full recourse to the respective (nonsecuritised) mortgage or public sector loan books as per above.

Derivatives registered in favour of covered bonds would also not accelerate; as with substitute collateral, none of the issuers have made use of this option to date.

Covered bond oversight

The Bank of Spain is generally supervising issuance of covered bonds and the compliance with established limits and remedies. The Comisión Nacional del Mercado de Valores (CNMV) monitors the issuers' compliance with a specific focus on ensuring that at issuance of a new covered bond, all conditions are met. In contrast to other countries there is no independent trustee monitoring compliance. Upon insolvency there is no special administrator managing the cover pool but the general insolvency administrator also manages the covered bonds.

Other legal framework considerations

The framework generally provides for UCITS and CRR compliance.

Generous levels of overcollateralisation in the past have protected investors and overcompensated most aspects that are no longer best practice in a European covered bond context. Also the slump in the Spanish mortgage market has put some of the shortcomings into the spotlight such as missing updates of LTV's for cover pool assets or the less pronounced active cover pool risk management.

The need to further improve the framework has been acknowledged by the Spanish treasury when they published a consultation in 2014 on possible changes aimed at

[5] The Spanish legal framework also allows for the issuance of bonos hipotecarias (mortgage covered bonds backed by a dedicated ringfenced cover pool) and cedulas internacionalización – covered bonds backed by export claims; both covered bond types are not actively used and therefore not covered in this report

[6] Spanish Mortgage Market Law (Ley 2/1981, de 25 de Marzo de 1981 and amendments by Law 41/2007, Insolvency Law (law 22/2003) and secondary regulation (Royal Decree 716/2009)

aligning the framework closer with EBA's best practice guidelines. Generally we believe that the proposed changes can introduce more transparency for investors and require issuers to actively manage their cover pools to maintain sound credit quality. We view positively that cover pools can become better defined and that issuers will be required to have a more pronounced liquidity and risk management more in line with other European covered bond frameworks. The consultation has not yet resulted in a draft of a new covered bond law and we do not expect a new framework to be introduced before the 2015 elections.

Generally, we believe that the current Cédulas framework meets most of the rating relevant provisions allowing the maximum two notches of rating differentiation.

Resolution regime assessment

Translation of BRRD into national law

Generally four notches uplift

Since 20 June 2015 the BRRD is effective in Spain and has been fully translated as the Spanish law Ley 11/2015 de recuperación y resolución de entidades de crédito y empresas de servicios de inversión. It confirms the preferential status of covered bonds upon insolvency.

The existing resolution and restructuring framework applicable to Spanish banks, introduced in 2012, already featured most provisions and resolution tools stipulated in the BRRD. All available resolution options were used in the significant restructuring of the Spanish banking sector during the crisis. We note that current practice did not impact holders of covered bonds demonstrating the systemic importance of this product.

Systemic relevance of covered bonds in Spain

Covered bonds are used by the majority of Spanish banks[7] to refinance mortgage lending. Volume of outstanding mortgage covered bonds regularly ranks among the top five countries worldwide. At the end of 2014 EUR 308bn of covered bonds were outstanding and annual issuance comprised EUR 25bn. Measuring the share of covered bonds as a percentage of GDP comes to a significant 30%. Spanish covered bonds are widely represented in investor portfolios.

In particular during the crisis, new covered bond issuance was used intensely to generate liquidity for banks. Compared to the EUR 25bn of issuance in 2014, 2011 and 2012 saw mostly retained issuance volumes of roughly EUR 100bn in each year. The ability to use covered bonds with the ECB at times when public debt markets were reluctant to accept new issuance from Spanish issuers highlights their strategic importance.

Systemic relevance of mortgage and public sector covered bonds

CH's are used widely for refinancing mortgage loans, but outstanding public sector covered bonds comprise only about 1/10 of mortgage covered bonds in Spain as of end 2014 (CH: EUR 282bn vs CT: EUR 25bn). We believe the lower systemic importance is likely to impact stakeholders' incentives to support the product.

Proactive stakeholder community

We believe Spanish stakeholders are highly incentivised to maintain covered bond funding as a refinancing option and existing practices during the restructuring of the Spanish banking market show that resolving or restructuring the issuer is unlikely to impact their covered bonds. Even though the Spanish covered bond framework has not benefitted from various improvements we see efforts to align existing framework with best practices as positive. We also see positive evidence of an active stakeholder community the recent update of the securitisation law that introduced the ability to establish more defined "structured" covered bonds. The amendments to existing covered bond law and transition to new structures will take time, but we see this as proof of a proactive stakeholder community.

We believe that the ongoing systemic importance of covered bond funding for Spanish banks supports a proactive regulatory oversight with the view to maintain the issuers as a going concern. We do not expect the use of resolution tools to negatively impact covered bonds.

All covered bond types are systemically important but we believe that public sector

[7] 31 active issuers as per the end of 2014

covered bonds are of less importance in Spain. They are only used by a smaller number of issuers and direct public sector lending is of lesser importance than mortgage lending. We therefore believe that a credit differentiation between the two covered bond types is warranted. For the resolution based uplift we would therefore only attribute a credit differentiation of three notches for public sector covered bonds whereas Spanish mortgage covered bond would generally be able to receive the full credit differentiation of four notches under our methodology.

Key Covered bond Framework characteristics: Spain

Issuer	All regulated Spanish credit institutions are allowed to issue Cédulas
Cover assets	First lien mortgage residential or Commercial mortgage loans within the EEA provided the security is equivalent to Law 2/ 1981 Public sector loans (no bonds) within the EEA issued directly by states, autonomous communities or local entities Substitution assets: up to 5% of the outstanding mortgage covered bonds; no substitution assets allowed for public sector covered bonds
Loan to value restrictions	Residential mortgage assets 80% LTV (higher LTV possible provided an additional guarantee or security are provided) Commercial mortgage assets max 60% LTV Valuation: full appraisal but only at origination Covered bond investors have a preferential claim covered assets – also on recovery proceeds in case the mortgage loan exceeds the LTV
Market and Liquidity risk guidelines	No specific liquidity or market risk guidelines stipulated by law
Coverage principle/ Minimum oc	CH: Covered bond issuance limited to 80% of eligible mortgage loans (translating into an effective oc of 25%); CT: issuance limit of 70% translating into an oc of 43%
Treatment upon insolvency	No acceleration upon insolvency
Mandatory Transparency	No mandatory
UCITS/ CRR compliance	Yes/ Yes
Special supervision	Bank of Spain and CNMV

Sweden

Covered bond type

Säkerställda Obligationer (SO - mortgage covered bonds)

Combined framework assessment

Eligible for six notches

Covered bond name	Primary collateral type	Legal Framework analysis	Resolution Regime analysis
Säkerställda	Mortgages	+2	+4

Legal framework assessment

Eligible for two notches uplift

The current Swedish covered bond framework was established in 2004. Similar to the French OF framework, public sector as well as mortgage assets that meet the eligibility definitions of the CRR can be refinanced. In practice, most Swedish covered bonds only contain mortgage loans as prime collateral.

The first Swedish mortgage bank was established in 1861 and mortgage bonds in Sweden had a long, established and untarnished credit history. However, they did not qualify for the preferential treatments other European covered bonds frameworks allowed for. The joint effort of domestic market stakeholders in early 2000 resulted in the establishment of the current framework allowing covered bonds to maintain the most important mortgage refinancing instruments for domestic banks.

Segregation of the cover pool upon insolvency

The legal covered bond framework in Sweden comprises the covered bond act of 2003 – lag 2003:1223 om utgivning av säkerställda obligationer, amended on 1 June 2010 and supplementary regulatory provisions (FFFS 2004:11; FFFS 2013:1). Similar to Germany, the cover pool which comprises the eligible cover assets, substitute assets, derivative contracts and all outstanding covered bonds, becomes isolated after the insolvency of the issuer. Covered bond holders have a preferential claim on all registered assets in the cover pool and have priority claim on cash generated by the cover pool. The issuers' insolvency does not trigger an acceleration of covered bonds.

Ability to make payments after issuer insolvency

The law allows for the inclusion of substitute assets, which facilitate timely payment of covered bonds after insolvency. The act does not stipulate a formal liquidity buffer such as the 180 day liquidity coverage. The law however stipulates that the issuer shall ensure the cover pool is able to timely pay the covered bonds and related derivative counterparties at all times. In particular for domestic covered bonds, liquidity management is facilitated by the standing practice of issuers to buy back maturing covered bonds proactively when they approach maturity and refinance the existing mortgages with new covered bonds. The framework also allows the cover pool insolvency administrator to contract liquidity for the cover pool to maintain this liquidity matching.

Remain programme enhancements available

The law does not stipulate a minimum overcollateralisation. However, some of the current risk management guidelines already result in an indirect overcollateralisation requirement to meet the stress test requirements for interest and currency risk. The covered bond act also ensures that overcollateralisation available at the insolvency remains protected. Derivatives rank pari passu with covered bonds, do not accelerate and remain available to mitigate risks even after insolvency.

Covered bond oversight

The Swedish FSA (Finansinspektionen) actively supervises an issuer's compliance with the act. Additionally, an independent inspector (oberoende granskare) appointed by the FSA is regularly monitors compliance of the cover pool, adequate management and issuance of covered bonds.

The inspector reports regularly and at least once a year to the FSA. He continues his activities after the insolvency of the issuer

Other legal framework considerations

Swedish covered bonds are UCITS and CRR compliant..

Resolution regime assessment

Generally for four notches uplift

Translation of BRRD into national law

As with France, Sweden has been notified by the European commission of its incomplete translation of the BRRD. As Sweden is outside the eurozone and thus not part of the ECB's supervisory framework, there could be more leeway in its translation into local regulation.

However, given the interconnectedness of Swedish financial institutions we expect Swedish regulators to broadly follow the BRRD and expect the preferential status of covered bonds in a potential restructuring to be ensured. It is our understanding that Swedish regulators will maintain a certain discretion and independence to ensure the functioning of the domestic market but it is unlikely to impact the status of covered bonds.

Systemic relevance of covered bonds in Sweden

Swedish covered bond issuers are both very active in international as well as their domestic market. Covered bonds outstanding are well above EUR 200bn and annual new issuance hovers around EUR 50bn in the past years. Given the strong focus of Swedish banks on mortgage lending and refinancing them primarily via covered bonds, outstanding mortgage covered bonds represent more than 50% of Sweden´s GDP. Also from an investor's perspective covered bonds are systemically important both resulting from the importance in banks portfolios for liquidity management as well as local investors need for SEK denominated and high credit-quality investments. All of the above supports our view of the strong support mortgage covered bonds are likely to receive.

Proactive stakeholder community

Some of the recent developments in the Swedish mortgage market (reducing maximum LTV's for new mortgage lending; introducing amortisation requirements) also support the credit quality of covered bonds. Further, domestic stakeholders have been active in identifying potential challenges for Swedish covered bonds and its framework early on and addressing them to avoid problems for both issuers and investors.[8]

We believe that covered bonds in Sweden are highly systemic important and there is a strong alignment of interests to maintain covered bonds as a going concern in case of an issuer in distress. We will generally assign the full four notches of uplift for the benefits of the resolution regime in Sweden as we do not expect the importance of and systemic support for covered bonds to change in the near term.

Key Covered bond Framework characteristics: Sweden

Issuer

Only credit institutions can apply for a covered bond licence

Cover assets

Mortgage loans (residential, commercial as well as agricultural); Commercial mortgage loans shall not exceed 10% of the mortgage collateral within the cover pool.

Public sector assets (direct or guaranteed exposures to sovereigns, sub sovereigns or other public bodies with taxation power the European Union)

Substitution assets: up to 20% of the outstanding covered bonds comprising government bonds, cash and credit institutions; FSA can raise this limit to 30% for a temporary period.

Loan to value restrictions

Residential mortgage assets 75% LTV

Agricultural assets max. 70% LTV

Commercial mortgage assets, max 60% LTV

Mortgage loans overdue by more than 60 days have to be removed from the cover pool.

Valuation: issuers are required to regularly monitor the market value of the mortgage assets that serve as collateral for loans included in the cover pool. If the market value of such a mortgage asset declines significantly (15% or more according to the preparatory works to the covered bond issuance act), then only such part of the loan that falls within

[8] e.g. the 2007 amendments of the act or the recent EBA notification by the local regulator not to enforce to sole focus on credit quality step 1 financial institution collateral because of concentration issues in the local market

	the permitted loan-to-value ratio will be eligible for inclusion in the cover pool; the covered bonds' priority right extends to the full loan however. A decline in the market value following an institution's bankruptcy would not result in a reduction of the assets to which holders of covered bonds (and relevant derivative counterparties) have a priority right, but may result in the cover pool failing to meet matching requirements.
Market and Liquidity risk guidelines	The law prescribes a set of market risk stresses (changes in interest rates and/or currency exchange rates) that need to be performed on a daily basis. Generally the law foresees a general matching of rates and maturities – which is not as strict as e.g. in Denmark. No specific liquidity provisions exist. Issuers are able to contractually agree on "soft bullet repayment structures" which only have been used selectively.
Coverage principle/ Minimum oc	The framework stipulates a nominal and NPV coverage. The latter results in an implicit overcollateralisation as the NPV coverage requirement needs to be met after applying market risk stresses
Treatment upon insolvency	No acceleration upon insolvency
Mandatory Transparency	No mandatory transparency requirements
UCITS/ CRR compliance	Yes/ Yes
Special supervision	Swedish FSA (Finansinspektionen) and independent inspector appointed by the FSA

Disclaimer

© 2015 Scope Corporation AG and all its subsidiaries including Scope Ratings AG, Scope Analysis GmbH, Scope Capital Services GmbH (collectively, Scope). All rights reserved. The information and data supporting Scope's ratings, rating reports, rating opinions and related research and credit opinions originate from sources Scope considers to be reliable and accurate. Scope cannot however independently verify the reliability and accuracy of the information and data. Scope's ratings, rating reports, rating opinions, or related research and credit opinions are provided "as is" without any representation or warranty of any kind. In no circumstance shall Scope or its directors, officers, employees and other representatives be liable to any party for any direct, indirect, incidental or otherwise damages, expenses of any kind, or losses arising from any use of Scope's ratings, rating reports, rating opinions, related research or credit opinions. Ratings and other related credit opinions issued by Scope are, and have to be viewed by any party, as opinions on relative credit risk and not as a statement of fact or recommendation to purchase, hold or sell securities. Past performance does not necessarily predict future results. Any report issued by Scope is not a prospectus or similar document related to a debt security or issuing entity. Scope issues credit ratings and related research and opinions with the understanding and expectation that parties using them will assess independently the suitability of each security for investment or transaction purposes. Scope's credit ratings address relative credit risk, they do not address other risks such as market, liquidity, legal, or volatility. The information and data included herein is protected by copyright and other laws. To reproduce, transmit, transfer, disseminate, translate, resell, or store for subsequent use for any such purpose the information and data contained herein, contact Scope Ratings AG at Lennéstraße 5 D-10785 Berlin.

Scope Ratings AG

Lennéstraße 5
10785 Berlin
T: +49-30-27891-0
F: +49-30-27891-100
Service: +49-30-27891-300
info@scoperatings.com
www.scoperatings.com