European Harmonisation: Covered Bond Market Benefits – if Standardisation Stays Balanced

Scope Ratings comments on the EC's proposal to reduce fragmentation in the covered bond market. Europe-wide product harmonisation might create more challenges than principle-based voluntary harmonisation, both of which can raise the minimum quality of covered bonds. Clarity on covered bond proposals is needed to assess their ability to achieve this goal.

Standardisation can only provide the desired benefits if it allows embedding of local market specificities – housing finance, the state of the housing markets, and insolvency regimes continue to vary significantly between European countries. A pan-European covered bond legislation has the task of addressing these differences within a single framework.

The EC's proposal contains credit-positive elements that can raise the minimum credit quality for most European covered bonds. The proposal therefore implies that an enhanced covered bond legal framework could ensure minimum credit quality for any covered bond.

Improved harmonisation and standardisation will help maintain preferential regulatory treatment of covered bonds in a potential bail-in scenario of its issuer. Though reliance on the cover pool is very remote, the envisaged minimum standards, however, should not divert investors from careful credit analysis. The issuing banks' credit strength will still vary and a cover pool's quality will remain a dynamic source of risk – even when complying with improved regulations.

Covered bond harmonisation to complement Capital Markets Union

On 30 September 2015 the European Commission (EC) gave further clarity on their "Action Plan" to establish the Capital Markets Union (CMU). The CMU is one of the main policy projects of the EC to support bank financing disintermediation, aiming to spur growth and ease market financing in the European economy.

Given that covered bonds are the second largest European debt class after sovereign debt, the EC has started working on reducing current national fragmentation in covered bond legislations[1]. Until January 2016, the EC is soliciting comments from market stakeholders as to whether voluntary convergence of national covered bond frameworks is preferable to an EU-wide covered bond framework.

Very high credit quality for all?

Current proposals could potentially improve the minimum credit quality a covered bond can support. To provide a more in-depth answer as to whether the proposal will provide a 'level playing field', the project's objectives should be clarified further:

- What minimum credit quality should a covered bond framework support?
- Should this quality also be supportable in times of stress?
- Should the framework ensure timely and/or a full repayment of covered bonds?

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

Challenging status quo puts finger straight on the pulse

Raising cover pool standards, despite lower likelihood to recourse

As the covered bond market finds itself in calmer waters, addressing fragmentation now is a sound approach and should enable smooth implementation.

Building on the EBA's analysis of European covered bond frameworks in previous years, the EC has taken on board most proposals for harmonisation and standardisation. Harmonisation is relevant as the current minimum requirements – the directive for Undertakings for Collective Investment in Transferable Securities (UCITS) and the Capital Requirements Regulation (CRR) – allow investors to apply preferential risk weights, despite existing differences.

The risk of only having recourse to the cover pool has become less remote thanks to the EU's Bank Recovery and Resolution Directive as well as more proactive banking regulation. Still, the EBA's analysis identified that even when complying with regulatory definitions for covered bonds established in UCITS or CRR, residual risks and differences are significant enough to question the product's strength in a stressed scenario.

Most issuers today have already added structural elements to enhance products and to align with best practice. Such issuer and program-specific enhancements support high-credit-quality covered bonds, but at the cost of adding extra fragmentation between covered bond programmes – even within the same country.

In times of stressed macroeconomic conditions for a member state or bank, specific risks (such additional issuer-specific supporting elements) have sometimes reduced, which also results in lower external credit assessments. In absence of, or with fewer, extra enhancements, investors have realised that just complying with regulatory requirements can deteriorate credit quality significantly – even resulting in covered bonds that cannot support investment grade credit quality.

Indirect harmonisation versus direct product regulation

Both approaches can provide benefits, but ease of implementation might differ

To reduce fragmentation, the EC is currently considering two options to enhance the legal framework for covered bonds:

1) Indirect harmonisation: Based on EBA best practice, eligibility criteria for the preferential treatment of covered bonds will be amended. Member states would have discretion to adapt their current frameworks and to include national peculiarities.

2) Direct product regulation (29th regime): The EC is also considering a specific covered bond regulation. This product regulation would provide a pan-European covered bond law that is optional for issuers, and to which they could eventually migrate.

As a rating agency, we are generally unbiased on these two approaches as both can adequately address these aspects. From a practical perspective, however, we foresee challenges for the '29th regime' approach, mainly due to differing insolvency frameworks and, to a certain extent, accounting regimes. We understand that among others, this spearheaded the establishment of covered bonds' assets residing in SPVs instead of remaining directly on the issuer's balance sheet.

Analysing and commenting on a legal covered bond framework from a rating perspective seeks to identify if i) the framework sufficiently protects allowing uninterrupted payments on covered bonds under law; and ii) the credit quality of the covered bond structure could be affected by the issuer's moratorium or insolvency. Furthermore, iii) the rating analysis aims to identify if covered bonds can benefit from the preferential treatment of the resolution regime. Lastly, iv) the analysis of the legal covered bond framework also supports the quantitative analysis. We identify if and how the framework further reduces the probability of default, as well as mitigating loss given default, on covered bonds. This focuses primarily on mandatory risk management provisions that address credit, market and liquidity risks as well as the adequacy of mitigation.

Proposal in detail

The EBA's report highlighted aspects in which current covered bond legislation remain vague, silent, and for which interpretation is needed to assess the impacts on covered bonds' credit quality. The EC's aim to standardise, harmonise and to become more explicit will help support products in times of stress.

The ultimate answer of whether a covered bond can survive after an issuer's default has not (yet) been given. Removing uncertainties could stabilise a covered bond's credit quality and enhance certainty for pricing and liquidity. Below, we will provide some credit-positive aspects and challenges we noted in the EC's publication.

Clarity on asset segregation and status of covered bond estate in wind down

Better comparability in a worst case scenario is positive

We view positively the proposal's aim to provide further clarity on the 'unthinkable' – a stand-alone covered bond program of a defaulted issuer. Generally we envisage that further clarifications would not be credit-negative for covered bond quality. Most aspects of a standalone covered bond have been thought through as well as discussed between lawmakers, regulators and insolvency practitioners. Also, assumptions have often been backed by legal opinions which, unfortunately, have not been made public.

Clarifying practical and legal aspects upon an issuer's insolvency can raise transparency for investors, remove barriers of entry and enhance fungibility of capital flows between member states.

Transparency on third party controllers

Similarly, transparency is limited on ongoing monitoring of eligibility criteria. The proposal intends to harmonise the role and abilities of both third party inspectors, such as the cover pool monitor or trustee, as well as the role of supervisors. Owing to differences in the status and ability of those inspectors, both before and after an issuer's insolvency, a harmonisation can provide more comfort for investors.

Maintaining cover pool credit quality, supervision after regulator intervenes

Quality maintained when issuer still active, but what happens upon resolution?

While much focus has been placed on the status of a covered bond's credit quality when supported by the issuer, we believe an enhanced framework should also clarify impacts of regulatory intervention and the application of the BRRD[2].

While an issuer's bail-in will not affect a covered bond, its credit quality can grow more volatile. Changes to business strategy after a regulatory intervention will likely be reflected in the cover pool. Asset composition will likely change, issuance behaviour might differ, and the decision of whether market funding or accessing the ECB's liquidity has first priority will have repercussions on the risk profile.

We view positively the proposal seeking to unite banking supervision via the Single Supervisory Mechanism with the current (rather domestic) product supervision. In a distressed situation, bank and covered bond supervisors could have different priorities,. We believe enhanced harmonisation should clarify that the 'no creditor worse off' principle also holds true when providing protection to covered bond investors. Without, joint supervision and potential workout might pose the risk that available

[2] An example is Austrian Kommunalkredit in which both the bank and the cover pool was split. While investors took some comfort that the split was done under the auspices of the regulator, information on the composition of the supporting cover pools and permanence of contractually committed overcollateralisation was not available for more than half a year.

overcollaterlisation over legal limits – initially to support high credit quality in covered bonds – could be provided to unsecured creditors to avoid a too-high bail-in.

Focus on maintaining high-credit-quality cover pool

Harmonising LTVs not as easy as expected and…

Among others, the proposal identifies the need for more clarity and harmonisation on asset risk and the maintenance of eligibility criteria. The proposal, for example, addresses valuation principles of eligible collateral. Regular revaluation requirements to support preferential treatment of cover assets are already under the CRR. Individual valuations of cover assets performed under the CRR are not necessarily used for monitoring cover pool assets, and practices can even vary between issuers in the same country. A common standard will raise transparency between cover pools as investors no longer have to understand whether the reported ratios show that the property's valuation at origination is i) at market value (or a lower mortgage lending value), ii) a revaluation between origination and reporting, or iii) an indexation of the origination value to a 'current' value.

Harmonisation of valuations is one of the most obvious aspects that should be addressed. The EBA, however, has actively advocated not to pursue a Europe-wide harmonisation of mortgage lending values given the "disruptive impact in the covered bonds market across the EU both from a legal and financial stability perspective"[3]. In our view, this exemplifies why Europe-wide product legislation could be disruptive.

Other aspects address cover pool composition over time and credit-relevant aspects such as concentration risks. From a credit quality perspective, we do not see significant changes, and see positively that enhanced transparency allows investors more awareness of pertinent potential fluctuations in credit quality, for example, if and to what a pool of commercial and residential exposures could migrate in order to become fully backed by the one of the asset classes.

Non-performing loans

…NPLs can also provide benefits

We view as positive that the commission is considering to derecognise non-performing assets and to continuously replace such cover assets – which is currently not explicit in all jurisdictions. During times when cover pools are no longer actively managed, such requirements can, however, have unintended and even negative consequences for covered bond investors. Depending on how it is applied after the issuer's insolvency and how a potential over-indebtedness is monitored, derecognising non-performing assets could call for an acceleration of the covered bonds.

Reflecting the credit quality of the collateral, the workout of a non-performing loan will still likely provide enough proceeds to support a full (but not necessarily timely) repayment of covered bonds. A derecognition and potential acceleration will likely result in a 'fire sale' of cover assets, reducing recovery proceeds for investors. More clarification is therefore needed on the treatment of such regulations upon an issuer's insolvency as well as on the management's focus on the insolvency administrator of the cover pool (full or timely payment).

Harmonisation of liquidity and other market risks

Liquidity and market risk finally addressed but…

A credit-positive in the proposal is the aim to harmonise and improve regulatory requirements for managing the less-visible market and liquidity risks to which a covered bond is exposed. Current regulatory criteria do not have much guidance on actively managing market and, in particular, liquidity risks.

[3] http://www.eba.europa.eu/-/eba-seeks-legislative-clarifications-on-mortgage-lending-value

The positive view reflects that managing market (interest and foreign currency) and liquidity risk more often has driven changes in a covered bond's credit quality than negative credit migration.

…Details matter

We understand the commission is concerned that, for example, intra-group hedges can amplify the sensitivity of a covered bond's credit quality against the issuer's credit deterioration. Prohibiting intra-group hedges as per the proposal removes this extra reliance. We believe established market standards, including collateralisation of the exposure and early replacement can mitigate this risk significantly.

Similarly, provisions that more explicitly address liquidity management guidelines are credit-positive because when an issuer defaults, bullet repayment risk is one of the most acute risks to which a covered bond is exposed.

Harmonisation will allow varying use as mitigants: i) soft bullet structures (extending the scheduled maturity of the covered bond by one year) or ii) conditional pass-through features. The trigger to extend the maturity in existing program often varies (such as at the issuer's discretion or based on a predefined test) and investors find it difficult to identify differences across issuers. Harmonisation of these features is desirable but any too-strict forms of harmonisation can be disruptive if issuers have to wind down existing covered bond programmes and start up new ones.

More clarity on overcollateralisation

Minimum or maximum OC? Dynamic OC!

A covered bond's credit quality is actively managed by the issuer who provides for varying levels of overcollateralisation (OC). The proposal seeks to address this by requiring minimum and maximum levels of OC.

As addressed in our questions above (what minimum credit quality should the framework support and under (which) level of stress should this credit quality remain supported?), introducing a static OC level will unlikely support stable credit quality over time. Changes to the issuer's credit quality will impact the covered bond, and the varying and changing combinations of risk a covered bond is potentially exposed to also require a dynamic assessment of this protective measure.

As issuers often address this by providing higher OC levels than required by law, more information is needed on the adequacy and persistence of such OC, in particular after a regulatory intervention or even the issuer's insolvency.

The proposal currently addresses some of these aspects by proposing further information on the OC (whether coverage is based on nominals, net present value or stressed net present value). These provisions will make OC calculations more comparable, but will not necessarily address the above mentioned dynamism, which is needed to support a stable credit quality.

Introducing a maximum OC to address encumbrance concerns for unsecured creditors could have credit-negative implications for covered bonds. For some covered bond programs, a maximum level of OC might prevent issuers from compensating for all risks in their covered bond programmes.

Current diversity in European markets needs balanced approach

Balanced and ongoing renovation of frameworks needed to keep them current

We believe the diversity of European mortgage markets and bank business models adds value to financial stability. Further standardisation and harmonisation of covered bond frameworks can add more stability as better regulation can improve the minimum credit quality of covered bonds.

A very restrictive covered bond framework that does not allow the inclusion of national features in respective markets could result in the opposite. This could severely restrict the borrower's access to affordable home-ownership finance and reduce access to long-term stable funding for banks.

We believe the varying dynamics of European mortgage markets and the domestic banking systems currently make it very challenging to apply a 'one size fits all' covered bond regulation. In contrast, amending current laws on covered bond eligibility criteria, taking into account the EBA's blueprint, will more easily allow country-specific aspects to be addressed, in our view.

Renovating existing frameworks, aligning with best practice, and incorporating a more proactive and flexible supervisory approach, such as in general banking regulations, can improve the stability and minimum credit quality of covered bonds. It will also facilitate cross-country covered bond investment across Europe, thereby contributing to establishing the European Capital Markets Union.

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