Norway first out of the blocks to align with EU covered bond directive

Norway's proposals to align its covered bond framework with the recently-approved EU directive are credit-positive. They allow for new types of covered bonds, raise eligible LTVs, increase over-collateralisation (OC), introduce mandatory transparency and a 180-day liquidity buffer, even for soft bullet structures. The changes will enhance Norway's framework, which is already among the strongest in Europe.

The Norwegian FSA (Finanstilsynet) published its take on the amendments needed to comply fully with the European covered bond directive on 13 January 2020, just five days after it became effective. Scope views positively the FSA's proactive approach, which reflects the high systemic importance of Norwegian covered bonds. About 50% of Norwegian banks' market-sensitive wholesale funding comprises covered bonds, which makes up one fifth of total bank funding (as of September 30, 2019).

The FSA's assessment provides a comparison between the current framework and the new directive as well as a detailed proposal of changes needed to fully comply with the EU directive. It was submitted to the Ministry of Finance in late December. With a blueprint for required changes, it now falls to the Ministry to start the process for setting relevant laws and render Norwegian covered bonds (OMF) as the first to be labelled as European Covered Bonds (Premium), or OMF-Plus as the local equivalent.

We do not expect the proposed changes to impact Scope's assessment of the fundamental credit support the legal framework can provide to covered bond ratings. This reflects the fact that the main provisions needed to establish, maintain and, upon the insolvency of the issuer, isolate a high credit-quality cover pool are already contained in the existing OMF Framework.

For existing Norwegian covered bonds, the FSA is raising the bar so they can attract the Premium designation. The proposed changes will not structurally change the existing framework but rather reshuffle and amend the Financial Institutions Act and related regulations[1].

New covered bond types – likely or theoretical?

Following the EU directive's distinction between European Premium and Standard covered bonds – both of which can differ in terms eligible assets and risk weights, the FSA is proposing to open up the framework for additional covered bond types. These could include covered bonds backed by public sector loans (OMF Plus) or collateralised shipping loans (OMF Standard).

The proposal allows for different covered bond types to be issued out of the same covered bond entity. To-date, Norwegian issuers that maintain two covered bond programmes (i.e. one backed by residential mortgages and another backed by commercial real estate) had to establish separate entities. The ability to issue them out of the same entity could improve efficiency and, given the strong separation of different cover pools, is generally neutral from a credit perspective. At the same time, it remains to be seen whether the market is willing to accept the changes or whether the option will remain purely theoretical.

[1] Chapter 11, Part II in the Financial Institutions Act and section 11 in the Financial Institutions Regulation

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Introduction of a liquidity buffer – even for soft-bullet structures

Norway embraced soft-bullet structures early on. Today, almost all Norwegian covered bonds are issued with a soft-bullet structure. Being the first to come up with a framework amendment, however, could provide the Norwegians either with the opportunity to establish a market standard for events that trigger extension, or the risk that it ends up being an impractical solution not followed by the market.

The Norwegian FSA has passed on the opportunity to become the trend-setter for the market. Instead, it is lobbying to have the discretion to formalise the measures just before the end of the transition period. This effectively means that Norwegian issuers will continue with less precise extension triggers. Only at the end of the transition will investors benefit from Norwegian triggers fully aligned with market standards.

At the same time, the FSA surprised the market as it not only asked for the belt but the braces too when it comes to liquidity buffers. The initial intention of soft bullets was to address potential liquidity problems upon the maturity of a large issue. With soft bullets becoming the Norwegian market standard for both benchmark but also smaller issues, the FSA reinforced the importance of sound liquidity risk management by covered bond issuers in good times – not just in stressed environments.

Scope views the dual provision as credit-positive, as liquidity risk is the main driver for the rating supporting OC. It will come at a cost, though, as Norwegian covered bond issuers will need to buffer the maximum cumulative net outflows from covered bonds over 180 days with highly-liquid substitute collateral. Since highly liquid and high credit-quality collateral currently yields next to nothing or even has a negative yield, the overall profitability of banks will be more pressured the more they issue benchmark bonds. However, at least in this regard the FSA has become a trend-setter. As the LCR already requires liquidity risk mitigation for the first 30 days, the FSA has effectively split the 180-day buffer requirement to avoid double provisioning of the same risk.

The FSA is effectively proposing reliance on the LCR buffer for the first 30 days so only requires the residual 150 days to be covered with collateral encumbered in the cover pool and then solely available for covered bond holders.[2]

Increased OC to buffer for changes and clarifications to eligibility criteria

To compensate issuers for the increase in the minimum OC to 5% from the current 2%, the FSA is proposing to raise the maximum eligible LTV for residential mortgages to 80% from 75%.

In Scope's view, the incremental higher maximum LTV will not increase the risk profile of covered bonds. Today, the average LTV in cover pools is in the mid-50s, well below the 75% maximum. In addition, macroprudential measures constraining a borrower's maximum leverage will curtail any significant migration towards higher LTVs thus will likely not prompt significantly higher average LTVs in Norwegian cover pools.

At the same time, higher LTVs will reduce pressure on the originating banks as they will receive further leeway as to when to exchange a loan that has become ineligible.

We view positively the fact that the FSA also aims to remove residual uncertainties, such as the treatment of eligibility criteria upon default. Even though not expected, the wording could have suggested that ineligible cover assets must be removed. In an extreme and worst case, this could have meant that a cover pool in wind-down would have become deprived of cover assets even though they could still provide regular proceeds and – even

[2] The FSA also allows collateral to be substituted with liquidity commitments by banks with a single A rating (CQS 2 and above) – a commitment already seen in the Norwegian market for joint covered bond issuing institutions

in default – recoveries. Rather than solely benefiting covered bond holders, proceeds would have had to be shared with unsecured creditors of the defaulted issuer.

Similar to the first country-wide definition of extension triggers, the FSA has not provided guidance on the calculation of a covered bond entity's wind-down costs – an often overlooked element that can push minimum OC level upwards. Rating agencies typically allow for the coverage of servicing costs from the running proceeds of the wind-down pool. Often these costs can be easily covered by the available excess spread (difference between the asset and liability margin).

In countries with generous lending margins such as Norway, wind-down costs do not materially contribute to the rating supporting OC, even leaving some margin to mitigate expected credit losses[3]. The FSA now expects the banks to come up with their own assessment of wind-down costs that have to be provided upfront in the cover pool. Depending on the timing assumptions of the wind-down, i.e. until the maturity of the last covered bond or the legal maturity of the last mortgage loan in 25 years, OC contributions from this calculation can easily fluctuate between an additional percentage point and an additional four to five points.

While further guidance on the most appropriate calculation method would have been appreciated, the ability of the FSA to approve (or not) the issuer's calculations will allow it to adapt to European market standards – once established.

Quarterly transparency – finally for all

EU harmonisation will provide investors with a more comprehensive view on the evolving risks within Norwegian covered bond programmes. In the past, smaller issuers have not provided investors with regular information on the development of risk. Being a core ingredient to achieve the OMF Plus designation, we view positively the fact that regular transparency reporting will now become mandatory for all.

Additional technical changes further strengthen established practices

The FSA proposal contains additional technical changes and will further formalise the tasks and powers of the supervisory authority. The FSA can impose more staffing within the covered bond entity. Similar to French covered bond issuing entities (SFH of SCF), the majority of Norwegian covered bond companies are solely managed by personnel of the parent bank.

These dual roles give rise potential conflict of interest in distress of the parent bank. This set-up also might challenge the ability to run a Boligkreditt in case the parent bank is in wind-down, which makes it sensible to grant the FSA the power to ask for independent staffing at the mortgage bank.

Proposed amendments also will make sure that the regular cover pool monitor is more independent than before. It stipulates that the cover pool monitor cannot be the same as the auditor of the parent companies, enhancing the system of checks and balances.

[3] Assuming a typical lending margin for residential mortgage loans of 150bp, Scope assumes annual servicing costs of 25bp. As a result, 125bp are left to cover for annual credit losses, which in Norway have hovered around 20bp in recent years for the whole loan book – including riskier consumer and corporate lending .

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