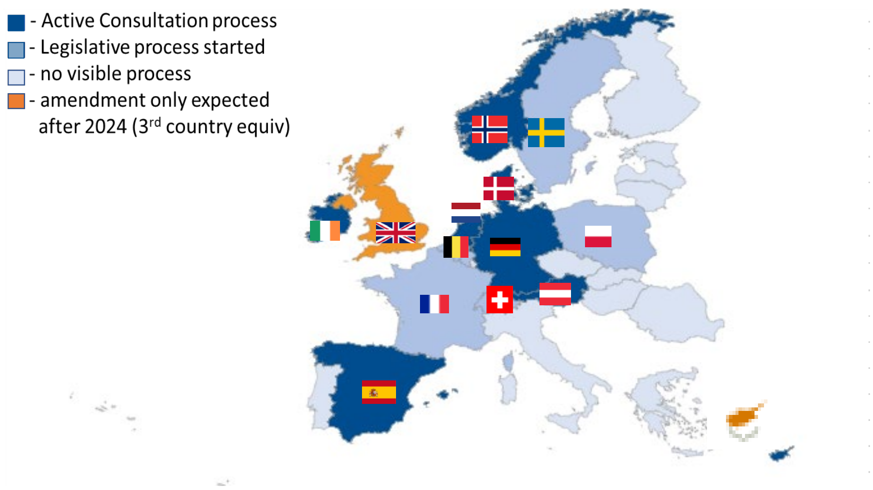
Austria's covered bond harmonisation: "One ring to rule them all" – transposing EU directive brings credit-positive consolidation

Austria's covered bonds are among the oldest in Europe, yet the country's legislation is also among the most fragmented: three different covered-bond regimes exist in parallel. The 8 July 2021 deadline to transpose the European covered-bond directive (CBD) will finally consolidate the existing legislation, both modernising it and bringing it in line with that of other EU members. The legislative update will largely please issuers and assuage investors' concerns. We expect the change to lead to higher issuance volumes and enhance the local market's systemic importance and cohesiveness. Improved credit quality might lead to an increase in the fundamental credit-support uplift and thus make Austrian covered bonds more resilient against downgrades.

The Austrian Ministry of Finance is on a tight timetable. The looming July 2021 deadline for transposing the European covered bond directive into domestic law requires a consultation with market participants before pushing the needed amendments through the upper and lower houses of parliament in less than four months.

Austria is not alone, though: as of today, no European country has fully transposed the covered bond directive, and some have not even published their consultations.

Figure 1: Current status European Covered Bond Harmonisation[1]



Source: Scope

In Austria, the different covered bond frameworks[2] resulted from the more pronounced historic sectoral differences between Austrian banks. The existence of a less cohesive and less vocal stakeholder group compared with other European covered-bond jurisdictions also meant that investor confidence in Austrian covered was lower. As a result, we also did not provide Austrian covered bonds with the highest fundamental credit support uplift[3].

[1] French and Belgian regulators currently only have bilateral, non-public consultations
[2] Depending on the past and legal setup of the issuer Austrian covered bonds are either governed by the „Hypothekenbankgesetz – HypBG" as of 1899, the „Gesetz betreffend fundierte Bankschuldverschreibungen – FBSchVG" - initially established in December 1905 or „Gesetz über die Pfandbriefe und verwandten Schuldverschreibungen öffentlich-rechtlicher Kreditanstalten – PfandbriefG" - dating back to December 1927
[3] Only up to 5 notches uplift for fundamental credit support compared to a maximum of six notches for highly supportive covered bond jurisdictions, see our covered bond framework analysis for Austria, available here

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Related Research

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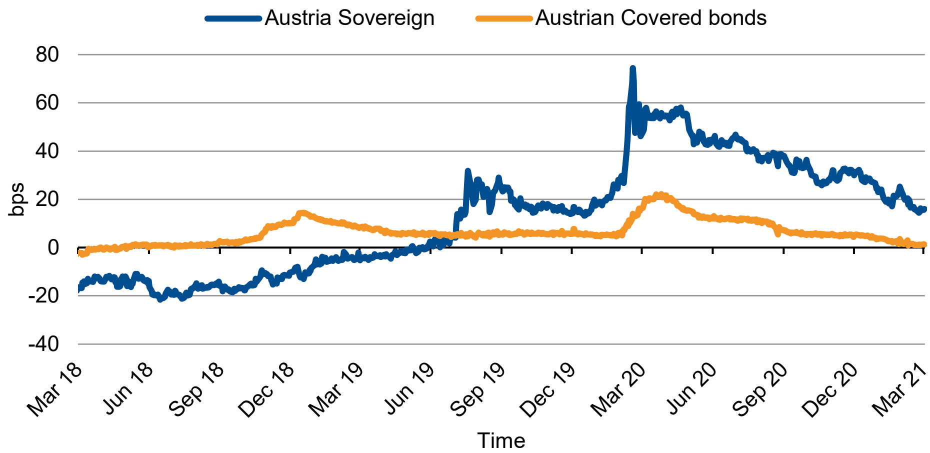
The lower support or certainty for investors was clear when Austrian covered bonds faced tests: the prominent examples were the moratorium and bail-in for Heta Asset Resolution AG – the work-out entity of failed Hypo Alpe Adria Bank - as well as Austrian Kommualkredit – both covered bond issuers[4]. As a result, investor appetite for Austrian covered-bond issuance was muted for some time and issuers needed to pay a premium compared with other European covered bonds.

Harmonisation at a time where past concerns have subsided…

Times have changed. Today Austrian covered bonds provide its issuers a cost-efficient funding tool. On an index basis, they can even deliver lower funding spreads than the Austrian sovereign.

Figure 2: Spread comparison Covered bonds vs Austrian sovereign spreads



Source: Markit, Scope

Furthermore, systemic importance has significantly increased. With outstanding covered bonds of more than Eur 70bn in 2020 (see Figure 3 on p.6), they represent more than 12% of Austrian GDP compared with less than 2% a decade ago.

.. but needed as EBAs 2016 peer comparison ranks Austrian cb framework weaker than most

Past changes to the covered bond framework were less stringent than in other jurisdictions, ensuring the Austrian covered bond framework fell behind prevailing standards. When benchmarked against the EBA’s 2016 harmonisation recommendations - which ultimately became the blueprint for the EUs covered bond directive - the Austrian frameworks met only seven out of 17 best practices. They ranked as one of the weakest in Europe. This is changing… at last.

“One ring to rule them all”

Consolidation of Austrian covered bond acts into one is credit positive

In its consultation[5], running until April 30, 2021, the Austrian Ministry of Finance proposes to reduce the complexity and finally consolidate the three covered bond frameworks into one - a much more complete overhaul than the cosmetic changes of the past. The proposed legislation provides more clarity and, at first glance, the basis to lift Austrian covered bonds into the premier league. Austrian covered bonds will warrant the “European Covered Bonds (Premium)” label and as such maintain preferential regulatory treatment for investors.

[4] For the former, covered bond investors faced an almost one-year radio silence on the fate of their covered bonds and protection status (aka investor reports including supporting overcollateralisation) and for the latter, it was not clear whether they would become investors in the (state-guaranteed) Bad-Bank or end up with the restructured issuer.
[5] Available here (only in German)

Proposals are comprehensive but still need some careful reading

The proposed covered bond act (Pfandbriefgesetz – PfandBG) is not yet accompanied by secondary legislation or further guidance which means that it is premature to attempt a final assessment of its impact.

Investors to benefit from better liquidity protection…

However, based on the current proposal, we see a balanced mix of updates. It fully transposes the European covered bond directive (CBD). As a credit positive, it addresses some of the past weak points – in particular, liquidity-management guidelines – and accommodates issuers. With the ability to use residential mortgages of up to an LTV of 80%, it widens the eligible collateral pool and lays the ground for further growth.

LTV limits become binding for all but LTV increases to 80pc

In the past, most Austrian issuers maintained a maximum LTV for residential mortgage secured assets of 60%. However, this was not a hard, legal requirement but a soft limit for issuers under the Mortgage bank act. Issuers of Fundierte Schuldverschreibungen did not have such a soft requirement but just adhered to it as a market standard.

It is credit positive that following the update all issuers will have to abide to the same rules. Surprisingly, however, the Austrian legislator also has used the update to increase the riskiness of eligible collateral available as a risk buffer to investors.

…at the cost of higher LTV thresholds

Referencing the eligibility criteria to article 129 (1) of the CRR means that also LTVs of up to 80% for residential mortgages will become eligible. From a credit risk perspective, a 60% limit – particularly if determined using a prudent, through-the-cycle valuation - typically means that, even in the case of a borrower default and, even in a stressed environment, a full recovery of the exposure is likely.

We expect that it will take a while before Austrian cover pools will see significantly increased average LTVs. However, the support needed for higher ratings through over-collateralisation will likely need a higher contribution for credit risk than before.

Risk mitigation: 180-day liquidity based on soft-bullet maturity

180d liquidity coverage will like prompt higher soft-bullet issuance in Austria

The most credit-positive change is the introduction of mandatory short-term liquidity risk mitigation. For Austrian covered-bond issuers, the amendment will introduce the requirement to buffer the highest net outflow within the next 180 days (including both principal and interest and carving out the period covered by the LCR) with sufficient high-quality collateral. To date, not all issuers provide such protection. In future, they will have to provide more active management, introduce higher amounts of such substitute assets into their cover pools and likely make more use of soft-bullet, redemption structures.

Credit quality of most Austrian banks has improved and will facilitate the provision of sufficient eligible collateral as defined in Art 129 of the CRR[6], including bank exposures rated AA, or even single A. However, we note that the Austrian regulators - for now - have not provided their banks with some of the possible credit mitigation. The CBD also allows for a partial waiver of the requirement to only use very short-dated exposures to BBB rated banks as a liquidity buffer. In circumstances in which the Austrian banking sector's credit quality weakens, collateral for the liquidity buffer becomes scarcer, potentially even introducing concentration risk to the covered bond cover pools.

The new liquidity requirements will introduce the maintenance of additional collateral as a buffer for the potential liquidity shortfalls. However, as maintenance of such collateral is

[6] See here for the most current version of the CRR

typically less efficient and costly for the issuers, we expect that Austrian issuers to make more use of soft-bullet redemption structures for covered bonds. This would allow them to avoid providing such additional collateral.

Objective reasons for the soft bullet trigger introduced….

As some Austrian issuers already make use of such soft-bullet structures it means that the respective section of the proposed act also needs to clarify the situations that could trigger the extension. As expected, the maximum 12-month extension can be triggered by i) the insolvency administrator if in insolvency and ii) if approved by the restructuring authority when the issuer is in resolution.

…ability to also trigger if not sufficient liquid assets can be provided…

At the same time, an extension can also be triggered iii) if the (still viable) bank can demonstrate to the supervisor that it cannot provide sufficient collateral to meet the 180-day liquidity requirements. While we see this early trigger option as positive, we caution whether the use of the option would not already seal the fate of the bank. As the extension will need to be made public, other creditors might start a run on the bank in question.

…and no further clarity on staggering of extended maturities - yet

The law also clarifies the CBD by ensuring that neither the ranking nor the time structure of existing covered bond will be altered by the extension. As the German transposition of the CBD has shown, the time structure element is one of the weak spots in the CBD that needs clarification. As the Austrian act remains silent on the ability to do partial (re-) payments, we would expect more clarity in the secondary legislation or through guidance on its interpretation from the European Commission.

Other market risk management guidance still weak

The CBD does not require regulators to introduce further guidance on market risk management (such as risk arising from mismatched interest or fx rates) on covered-bond programmes. Section 3 of the proposed act remains vague on the risk tolerance and whether adverse market risk situations have to be used to test that the respective coverage requirements are also maintained in those situations.

Issuers need to provide a reserve for prepayment risk

In §8, the proposal expects issuers to provide a reserve of eligible cover assets to ensure sufficient coverage also in case of sudden rise of mortgage prepayments. We see this as a credit positive as prepayment risk is one of the main risk drivers for Austrian mortgage covered bonds. Austrian consumer law is relatively consumer friendly as it gives mortgage debtors the right to prepay their mortgages at any time with little to no prepayment penalties.

Only 2% minimum over-collateralisation - is it enough?

Will all-in minimum over-collateralisation be higher than the 2% minimum?

The CBD aims to generally increase the minimum over-collateralisation to 5%. Provided certain risk reducing conditions are met, a lower minimum threshold can also be used. The current Austrian draft legislation provides only for a minimum of 2%, but we realistically would expect issuers to provide higher amounts. Even though no guidance is provided on how the lump-sum calculation of wind-down costs according to §9(4) Nr.4 has to be performed, we observe that several other transpositions of the CBD assume a 2% minimum for the outstanding covered bonds. As the 2% minimum over-collateralisation has to be in addition to the provision of wind-down costs, a sole minimum of 2% will realistically not be achievable for a covered bond.

Furthermore, from a rating agency perspective, we question the merit of any non-dynamic minimum level of over-collateralisation as it does not set the minimum in relation to risks.

To that extent, we have no preference for whether the 2% or 5% is provided. At the same time, we rather view as beneficial the clarification that issuers can provide more than the minimum which according to our understanding would then also be insolvency remote.

Mandatory transparency – finally codified

Regular risk reporting is credit positive

We see as a credit positive that quarterly reporting will be mandatory, a requirement which most Austrian issuers already comply with on a voluntary basis. The requirement to regularly disclose "information on market risk, including interest, foreign exchange but also credit and liquidity risk[7]" might help to introduce greater market discipline among issuers. In absence of further guidance on how these risks should be managed (see above), disclosure on the actual level of risk is at least a step in the right direction.

The regular reporting requirement is a positive for investors and should help to avoid uncertainties as in the cases of HETA and Kommunalkredit. Adding deadlines for the reporting could provide additional comfort, however.

More focus on full instead of timely payment?

Is clarification on timely vs full payment needed?

In the past, our understanding was that not only full but timely payment could be expected based on the three Austrian frameworks. This reading might need some further clarification. The proposed §4 section 2 stipulates only that coverage should be sufficient to secure the full payment of outstanding covered bonds. While section 5 provides for the 180-day short-term liquidity protection, we have found little guidance on whether the insolvency administrator should also secure a timely payment and a clear explanation of the means to ensure it. The Austrian legislation therefore points to a relative weakness of the CBD which does explicitly address this topic. We would expect further guidance on the tasks of the insolvency receiver, in particular, what the "required administrative tasks" ("erforderliche Verwaltungsmaßnahmen") are.

Oversight harmonised but only internal trustees as regular stop gap

Removal of the external versus internal trustee…

Another change from the previous set-up will be the introduction of an internal instead of an external trustee charged with ensuring compliance with the provisions of the act. The proposed act prescribes a relative independence of this internal trustee from the normal operations of the bank, notably that management is not allowed to direct the internal trustee. We view positively that formal registration and risk management are part of the internal trustee's tasks. However, even though the Austrian legislation is not the only one allowing for such internal solutions, generally an external trustee is less at risk of a conflict of interest than an internal solution.

… and is supervisory oversight adequate?

Generally, the dedicated covered bond supervision as described in the 4th main section of the act could reduce potential concerns. We view positively that supervision by the regulators will have to increase. However, according to §37 of the proposed act, only in cases where a breach has occurred will issuers notify investors on non-compliance. In some jurisdictions where internal trustees are the norm such as Denmark, proactive regulatory reporting on tasks performed and findings (or their absence) builds trust by demonstrating that a functioning system of checks and balances exists.

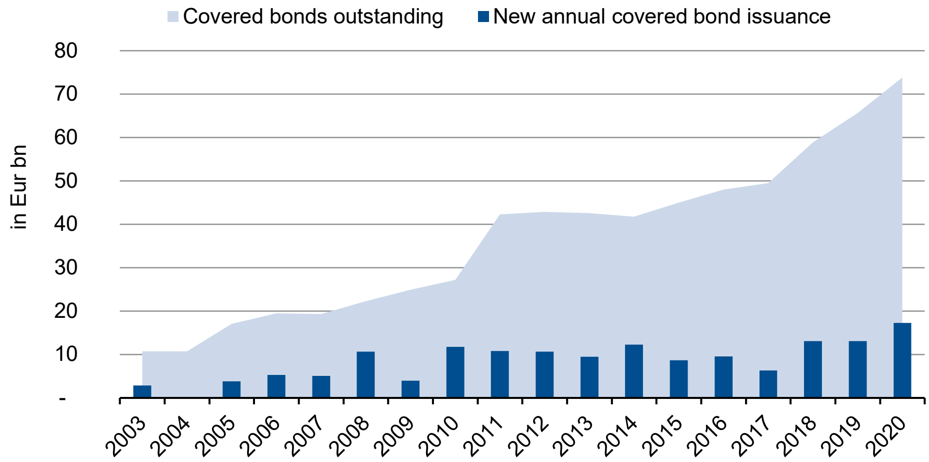
[7] See §23 (2) Nr.4. of the proposed act

Clarification on pooling options could mobilise further collateral.

Clarification on pooling is credit positive and might mobilise more collateral

Top and second-tier institutions in their respective sectors already make use of pooling options in the past given that savings and cooperative banks provide most of residential mortgages in Austria. Clarifications provided in the framework update might further increase the share of mortgage loans that can be mobilised, spurring further issuance.

Figure 3: Covered bonds increasing as a refinancing tool



Source: ECBC, Scope

More covered-bond pooling… perhaps only in theory

We generally assess direct rather than indirect mobilisation of collateral as credit positive. As seen most prominently in Norway, it can provide very small institutions capital market funding that they would be unable to attract by themselves.

Austrian mortgage banks were also among those that have used an indirect mobilisation via a unique Austrian joint-issuer model. A now decommissioned law, the Pfandbriefstellengesetz, coupled with a joint and several guarantee by the then still state-guaranteed Landeshypothekenbanks, allowed the banks to pool individual covered bond issuance to achieve economies of scale. Pooling also facilitated regular fund raising and the enabled Pfandbriefstelle to place bonds with international investors that they individually would not have been able to attract.

The currently proposal seems to reintroduce the concept, not only for the Landeshypothekenbanks. However, with the current draft and specifications, we wonder whether this introduces only a theoretical option. Lower-tier providers of collateral would need to provide them in form of smaller covered bonds. They would need to maintain all the processes as if they were a mortgage bank. However, the wording suggests that that the pooling institution should not combine those "mini covered bonds" with those of other issuers from within the group8. The provisions might be sensible in certain cases (such as mobilising collateral from non-domestic subsidiaries) but we fail to see the benefits of not being able to pool multiple bonds from different institutions from within the group.

[8] Supplementary documentation to §13 says that cover pools of a "pooling institution" should not contain covered bonds from multiple institutions from within the group.

The act already provides the necessary options for SME covered bonds but also multiple cover pools – a credit positive

Multiple covered bond programs of the same collateral type provides new options

The current proposal stipulates separate covered bond programmes with collateral that either allows compliance with the European "standard" or "premium" covered-bond labels. With a wide wording for "standard" covered bonds, Austria's legislators are already preparing the ground for possible addition: SME covered bonds.

The wording of the sections which clarify the types of covered bonds possible, also allow for the reading that issuers can provide several covered bond programmes with the same collateral.

If put in practice Austrian issuers could follow the best practice of Dutch issuers to set up dedicated "retained" covered bond programmes. This is relevant as the majority of issuance in the past four years was targeted at generating TLTRO or CBPP3 compliant, often retained collateral. Such issuance often had shorter tenors or non-standard interest fixings, putting existing investors at risk of becoming "time-subordinated".

Allowing for multiple mortgage-backed programmes would also allow Austrian covered-bond issuers to be more innovative, say by launching dedicated ESG covered-bond programmes which comprise only green or other ESG-compliant cover assets.

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