EUROPEAN CENTRAL BANK
EUROSYSTEM

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Covered bonds in the European Union – ECB contribution to the European Commission's public consultation

1. General remarks

As a follow up to the Green Paper in the context of the Capital Markets Union (CMU), the Eurosystem welcomes the European Commission's consultation on covered bonds in the European Union (EU), and in particular on how to achieve a more integrated European covered bond market. As one of the largest private debt markets in the EU, covered bonds are an important source of long-term financing for the economy, and therefore support long-term economic growth. Overall, the European Central Bank (ECB) agrees with the Commission's analysis regarding the advantages and disadvantages of harmonisation in respect of the covered bond market.

The ECB's response to the consultation is structured as follows: first, the key messages are highlighted under (**1**) General remarks, while more detail on some of the specific questions raised in the consultation document is provided in the subsequent sections, including: (**2**) Covered bond markets: economic analysis; (**3**) Exploring the case for a more integrated framework; (**4**) Covered bond definition; (**5**) Covered bonds and the system of public supervision; (**6**) Dual recourse and the insolvency/resolution regime; (**7**) The cover pool; (**8**) Over-collateralisation; and (**9**) Transparency.

The ECB is in favour of a high-quality and transparent EU covered bond market, and sees potential for harmonisation of some standards and practices across the EU. In line with market participants' views, the ECB generally considers the existing covered bond frameworks to be well-functioning and recognises that many national legal frameworks for covered bonds are long-established.

Regarding the economic analysis, there seems to be little supporting evidence that differences between national covered bond frameworks (e.g. transparency, legal/regulatory framework, or supervisory approach) *caused* the pricing divergences observed between 2007 and 2012. Rather, covered bond pricing divergences across countries appear to have largely been driven by domestic sovereign bond yields. Even though the functioning of the covered bond market remained resilient in episodes of market stress, the ECB concurs with the assessment of the Commission that it is desirable to achieve further harmonisation of specific features of covered bonds that will lead to further convergence towards a common high European standard. In this respect, future policy efforts aimed at harmonising covered bond frameworks should be ambitious. Common minimum standards should be introduced in areas where the benefits of harmonisation have been ascertained. A sufficient degree of flexibility should remain to account for some diversity across national regimes where this would not endanger the objective of having a common framework that facilitates cross-border covered bond comparisons and market activity. Moreover, such initiatives should be coherent with other EU-level policy agendas and projects to promote high standards in European capital markets and instruments.

Regarding enhancements to the legal/regulatory framework underpinning the EU covered bond market, as pointed out by the Commission, various options may be considered for achieving these goals. One approach (Option 1) would be to support non-binding, market-led initiatives. In the ECB's view, this would provide useful inputs, but may not achieve the necessary convergence, since these initiatives are only implemented on a voluntary basis. Another approach would be to provide for enhancements to the covered bond frameworks at the EU level. This approach has two variants. One variant (Option 2a) envisages enhancements to the covered bond framework that would promote further harmonisation of national regimes by means of introducing additional prudential and/or product-related requirements in Article 129 CRR and/or Article 54(2) UCITS (as well as relevant provisions in the Solvency II Directive). A second variant (Option 2b) is to establish a comprehensive covered bond legal framework ("29th Regime") stipulating high standards. The latter framework could initially co-exist with or potentially replace national legal frameworks over time. The ECB sees merit in the notion of a comprehensive covered bond legal framework over a medium to long-term horizon, following a harmonisation and convergence process based on a dedicated covered bond legal framework. The ECB is of the view that further harmonisation achieved through such a convergence process would be desirable and beneficial for covered bond markets. The ECB therefore sees merit in starting with Option 2a, which could over a medium to long-term horizon converge into Option 2b.

The ECB response therefore makes suggestions on the implementation of specific content where it seems best suited. For example, where only investing credit institutions are addressed by particular requirements, implementation of prudential measures in Article 129 CRR may be considered. Recognising that any change to the eligibility criteria of Article 129 CRR may have a wider impact on prudential requirements for investing credit institutions, potential changes should be implemented over a sufficiently long transition period with appropriate grandfathering provisions. For matters, such as transparency, that affect the entire market – both issuers and investors – a directive or regulation may be deemed more suitable.

Turning to more specific elements for an integrated EU covered bond framework, the ECB observes the following:

Covered bond definition: The ECB agrees in principle with the Commission's proposed definition, but is somewhat sceptical about extending the definition of undertakings for collective investment in transferable securities (UCITS) to also include covered bond issuers established in third countries (i.e. non-EU/EEA countries). Such legal and regulatory regimes would need to be assessed by the Commission as being equivalent to the EU framework as regards equivalent supervision, insolvency remoteness, and the dual recourse feature in the case of issuer default, which might be challenging. Moreover, national insolvency regimes and enforcement procedures available to secured creditors (e.g. efficient foreclosure following mortgage default) may differ substantially. Against this background, the ECB is not in favour of widening the location criteria to equivalent third countries for issuers that have their registered office in a non-EU/EEA country.

The appropriateness of the regulatory treatment: The ECB considers it important that the overall regulatory treatment of covered bonds (i.e. the Capital Requirements Regulation (CRR), liquidity coverage requirement (LCR), Solvency II, including due diligence, transparency and reporting) should reflect their unique features, but also their similarities with substitutes for such instruments, so as to maintain consistent regulatory treatment. Although the ECB considers the regulatory treatment of covered bonds under Article 129 CRR to be prudent overall and consistent with the resilience of covered bonds historically, it is worthwhile exploring options to increase the risk-sensitivity of covered bond prudential treatment, including with a view to providing the option of reducing reliance on ratings from credit rating agencies. Such options could include looking at, for example, the segregation and quality of the cover pool, the quality of the issuer, or the quality of mitigants to liquidity or operational risks. The ECB considers it important that the legal/regulatory framework envisages the inclusion of a liquidity buffer to cover net outflows from the covered bond programme over a certain period of time. In addition, the appropriateness of preferential risk weight treatment should be monitored on an ongoing basis, including in the light of continuous innovation within the covered bond asset class, like, for example, a more pronounced usage of non-standard amortisation structures, such as conditional pass-through covered bonds.

Loan-to-value (LTV) limits: The legal/regulatory framework should establish LTV limits with a clear distinction between residential and other loans. In line with current rules in the CRR, the LTV limit for residential loans should be substantially different from the one for other loans in order to reflect differences in risk. Set LTV limits could either be used for the calculation of the over-collateralisation ("soft" LTV limit) or as an eligibility criteria applied at inception and on an ongoing basis ("hard" LTV limit). An additional average LTV limit at the portfolio level could be considered in the case of soft LTV limits. The valuations should be carried out, in line with nationally recognised best practices, by an agent that is independent of the credit granting process. Both residential and commercial valuations should be updated and disclosed at least on an annual basis, for which purpose indexation or other statistical methods could be used. It should be made transparent how indexation has been conducted. For valuations exceeding a certain threshold, in addition to the indexation, new valuations should be considered periodically. A loan-to-income (LTI) ratio requirement at issuance of the mortgage, as provided for in the Mortgage Credit Directive, taking into account national specificities, could complement LTV limits, but should not replace them. This should especially be considered in the case of soft LTV limits.

Public supervision and the potential role of the Single Supervisory Mechanism (SSM): The SSM Regulation confers tasks on the ECB in the area of prudential supervision and provides it with an overall mandate to ensure the well-functioning of the SSM. The ECB supervises significant credit institutions in participating Member States directly, while national competent authorities (NCAs) are responsible for the supervision of less significant institutions under the oversight of the ECB. However, the legislative framework on covered bonds is likely to also contain rules which would not be prudential in their nature. Therefore, in principle and from a legal perspective, any specific role conferred on the ECB in the legislative framework on covered bonds would, by definition, be limited in scope to the prudential supervision of credit institutions and exclude supervision of product markets. In practice, the potential benefits that could be reaped from additional harmonisation of national covered bond legal frameworks are more substantial at this stage than those which could come from the direct European supervision of covered bond issuances. In addition, NCAs are in a better position to carry out product supervision of covered bonds as a result of their past experience, as the supervision of covered bond issuers in this respect requires very specific expertise and knowledge of national frameworks, which differ from those necessary to carry out prudential supervision.

Dual recourse: The Commission proposes a definition for “dual recourse” which goes into more detail than Article 52(4) UCITS. The ECB agrees in principle with the Commission’s proposed formulation as it captures the essence of dual recourse, i.e. full recourse against the issuer, being a credit institution which is subject to a supervision regime in line with Article 52(4) UCITS, and a priority claim on the segregated assets in the cover pool in the event of issuer default. The ECB, however, suggests some refinements in line with the overall approach to promote a level playing field in the EU.[1]

Segregation of the cover assets: Whereas the Commission raises the question of whether or not the use of a special purpose vehicle (SPV) would enhance the covered bond as an additional asset segregation mechanism, the ECB is not of the view that the use of an SPV in all covered bond structures would constitute an improvement. The ECB notes that, in line with Article 52(4) UCITS, any covered bond issuer in the structure should be subject to a supervision regime. It is therefore the ECB’s view that any initiatives on segregation would be better focused on mechanisms that ensure accurate asset identification and independent and effective administration of the identified cover pool assets.

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[1] The ECB proposes the following amendments to the definition of dual recourse:
“… the Framework could provide that ‘regulated’ covered bonds must grant the bondholder:

- a ~~direct~~ claim against the **assets included in the** cover pool on a~~n absolute~~ priority basis upon default of the issuer. ‘~~Absolute p~~**P**riority basis’ means that the proceeds from the **assets included in the** cover pool must be applied to ~~re~~pay principal and interest~~s~~ due to bondholders in priority to ~~all~~ other creditors of the issuer~~. The issuer's default may be triggered upon its resolution or declaration of insolvency~~; and
- a full recourse claim against the issuer for the timely ~~re~~payment of principal and ~~payment of~~ interest~~s attached to~~ **due under** the covered bonds. ‘Full recourse’ means that bondholders must be entitled to the proceeds from the liquidation of the issuer’s insolvent estate **on a pari passu basis with** ~~as~~ **the issuer’s** ‘unsecured creditors’ ~~for~~ **to the extent of** any deficit that may result from applying the proceeds of **the assets included in** the cover pool to **pay all amounts** ~~meet all liabilities~~ due to them on a~~n absolute~~ priority basis as set out above.”

Resolution/insolvency proceedings: The ECB notes that it may be feasible for the resolution authority to initiate the transfer of both the cover pool of assets and the liabilities to covered bondholders to another covered bond issuer/specialised credit institution or to a bridge bank, guided by the resolution plan of the issuer. It is therefore important that the initiation of resolution/insolvency proceedings against the issuer does not automatically accelerate payment obligations towards bondholders. A special administrator (in addition to the administrator for the insolvency) may be appointed for the cover pool to protect the interests of bondholders. While preparations are underway, including the valuation of the assets in the cover pool to determine any potential excess/shortfall, adequate liquidity is needed to meet regular payments to bondholders, e.g. by drawing on covered bond liquidity buffers. The ECB agrees that independent valuation of the cover pool assets is important in resolution, and the resolution authority will appoint a qualified and independent valuation expert to conduct a fair, prudent and realistic valuation.

Eligible assets in the cover pool: A robust covered bond model should be shielded against risky assets. One of the generally-accepted premises of covered bonds is that only prime assets from credit institutions' balance sheets are used as underlying assets in the cover pool. In addition, the issuance of covered bonds was traditionally aimed at financing only a part of the balance sheet. These are important reasons for the success of covered bonds over the years and their resilience during the financial crisis. In this respect, both mortgage loans and public sector loans are considered prime assets. In assessing whether loans to small and medium-sized enterprises (SME loans) may be included in a cover pool under a legislative covered bond framework in the future, however, a thorough analysis would be useful in order not to jeopardise one of the fundamental aspects of covered bonds, namely the inclusion of only prime balance sheet assets. The ECB shares the prudential concerns expressed by the European Banking Authority (EBA) and finds it appropriate not to include loans secured by aircraft liens and to exclude loans secured by ships from the preferential risk weight treatment.

Mixed pools: In line with EBA observations, homogeneous pools consisting exclusively of one asset class are preferred in principle. Nevertheless, for residential and commercial loans, mixed pools could be considered, subject to appropriate disclosures and safeguards to ensure that the risk profile of the pool does not materially change over time. In addition, a prudent concentration limit in respect of individual obligors should be established. The ECB notes that further work is required in the light of the current regulatory treatment of such pools under Article 129 CRR. The ECB takes note of the EBA's prudential concerns in relation to the use of residential mortgage-backed securities (RMBSs) and/or commercial mortgage-backed securities (CMBSs) in cover pools and concurs with this view. Regarding limits on exposures, the ECB finds it prudent to regulate and limit substitute assets according to strict criteria or, alternatively, substitute assets should not be taken into account in the calculation of the coverage requirement such that risks are limited to the cover pool assets.

Over-collateralisation (OC): Achieving a common standard on OC requirements would be challenging, and the best prospect for doing so would be a simple nominal

OC requirement (e.g. a legal minimum OC, in nominal terms). Rather than recommending a maximum OC level, the ECB would welcome sufficient information and transparency on underlying pools to enable market participants to assess the adequacy of asset encumbrance and to provide supervisors with the appropriate tools and metrics to monitor the overall encumbrance level of institutions. Sufficient transparency on OC should be supplemented by harmonised guidelines for the authorities competent for the supervision of covered bond issuers with regard to OC. In addition, further certainty should be provided for "committed OC", whereby, in principle, any reduction should be subject to an appropriate corporate governance procedure, including, for example, external bondholder consent. Finally, an EU covered bond framework should provide that, in the event of insolvency/resolution of the issuer, voluntary OC is an integral part of the cover pool and is protected for the benefit of bondholders.

Harmonised transparency regime for investors and other stakeholders: A key lesson from the global financial crisis was that investors should be able to perform adequate due diligence on their investment opportunities, covering the issuer, the underlying structure, the counterparties involved and the underpinning legal arrangements. Against this background, covered bond transparency should be seen as a way of enabling market participants to investigate covered bonds and to reduce their reliance on rating agencies.

The ECB supports the EBA's analysis in which it is noted that the current transparency requirements in Article 129(7) CRR may leave excessive room for interpretation for both issuers and competent authorities. In addition, the disclosure requirements in Article 129(7) CRR are insufficient to provide a sufficient degree of clarity on the health and risks of a covered bond programme, both for investors and for wider covered bond market participants. Hence, the ECB agrees with the Commission that issuers should disclose, in a consistent manner, data on credit, market, and liquidity risk characteristics with adequate granularity and that issuers should include any information that may seem useful for the performance of prudent due diligence on covered bonds, albeit with due regard to a cost benefit analysis of new requirements. In order to reduce duplication of reporting and to facilitate comparisons, the ECB recommends that the Commission explore greater centralisation of information disclosure.

Issuers of coved bonds could also be encouraged to facilitate the availability of a cash-flow model – potentially using third-party software providers' platforms – to allow stress tests to be conducted by investors. Indeed, the European Covered Bond Council's (ECBC's) Harmonised Transparency Template (HTT) and the templates of three major rating agencies all require substantially more information on both the cover pools and the programme structure than Article 129(7) CRR currently prescribes. The disclosed information may be grouped into three categories: (i) issuer and programme-level information, (ii) covered bond liabilities information, and (iii) cover pool information. Finally, the ECB is of the view that transparency surrounding processes related to the amendment of covered bonds (via "consent solicitation") should be enhanced (for example, through disclosure of more precise data on voter participation and publication of amended documents) in the light of the fact that such amendments are becoming increasingly common and, as highlighted by a number of analysts, a binding decision could in principle be approved by a small minority of bondholders. The ECB therefore believes it would be worthwhile to explore common thresholds for bondholders' consent and quorum requirements in the case of amendments of covered bonds, as well as consent fee arrangements that benefit all bondholders following programme amendments.

The ECB would more generally welcome a joint effort by stakeholders (market participants, regulators, central banks, etc.) towards making already available information accessible in a more standardised format from a common point of access.

2. Covered bond markets: economic analysis

In your opinion, did pricing conditions in European covered bond markets converge and diverge before and after 2007, respectively?

Cross-country differences in covered bond pricing were limited prior to the global financial crisis, but increased substantially between 2007 and 2012. The divergence in pricing culminated during the sovereign crisis, as illustrated by the rise in covered bond yields and the widening of covered bond swap spreads. Since July 2012 covered bond pricing differences have been decreasing steadily.

Was pricing divergence an evidence of fragmentation between covered bonds from different Member States?

There is little direct evidence that differences in legal/regulatory frameworks caused pricing divergence. Pricing divergence was a consequence of financial and economic fragmentation across the euro area jurisdictions which also affected sovereign and unsecured bank bonds, as well as other asset classes.

The increase in covered bond yields was mainly linked to the rise in domestic sovereign bond yields (partly due to the sovereign-bank linkages mentioned in the consultation document). Beyond this, there is little evidence of abnormal pricing divergence of covered bonds across jurisdictions. Indeed, the widening of covered bond spreads over the respective sovereign bonds yields was relatively contained throughout the financial crisis. Moreover, in formerly stressed jurisdictions the covered bond yields of the largest issuers were systematically lower than the respective sovereign bond yields, which suggests that the quality and structure of those covered bonds were perceived as sufficiently robust to partly compensate for the deteriorating sovereign credit quality. However, the quality of the issuer and the collateral mattered more in episodes of market stress, for example, as investors avoided covered bonds from weaker issuers with perceived lower loan underwriting standards. This arguably led to additional spread widening on covered bonds of weaker issuers within the same jurisdictions.

Do you agree with the reasons for market fragmentation described in section 2.1 of Part I?

Although the ECB agrees with the overall conclusion of the Commission's analysis, the ECB would highlight more clearly the sovereign risks and vulnerabilities within the banking system as a whole to provide a more accurate analysis.

The ECB takes the view that differences in legal/regulatory frameworks are relevant, but to a lesser extent than economic differences. For example, while investors differentiated legal/regulatory frameworks before and during the crisis, the statement that investors were unwilling to rely on certain legal/regulatory frameworks to provide effective protection to bondholders is inaccurate. It may be noted that there was no insolvency of a covered bond issuer during the financial crisis, which contributed to the overall perceived robustness of this asset class. This could provide an argument for a gradual approach to harmonisation of the covered bond market, focusing on certain elements where the benefits of converging towards a common higher standard can be clearly demonstrated. Moreover, harmonisation initiatives should leave sufficient flexibility to allow national specificities where this would not endanger the objective of having a common framework that facilitates cross-border covered bond comparisons and market activity.

Were there any other reasons?

Other reasons for market fragmentation had a smaller effect on the covered bond market than concerns about sovereign bonds and the banking system. First, the practice of rating ceilings with a maximum potential uplift above the sovereign rating potentially exacerbated the vulnerability of some covered bond markets. Greater transparency could help address this issue, as it would enable market participants to investigate covered bonds themselves and reduce their reliance on rating agencies. Second, lower secondary market liquidity in certain jurisdictions might have reduced their appeal. Initiatives aimed at supporting secondary bond market liquidity are therefore welcome. Third, regulatory treatment also mattered, e.g. whether the covered bonds benefited from preferential risk weight treatment under Article 129 CRR.

In your view is there any evidence of pricing differentiation/fragmentation between covered bond issuers on the basis of size and systemic importance, as well as their geographical location?

There is ample evidence that covered bonds issued by systemically important banks tend to have lower yields than those issued by smaller banks. Market participants frequently differentiate between “tier 1” banks (large banks, including domestic “national champions”) and “tier 2” (medium-sized) banks. In addition to factors related to the systemic importance of the banks, other factors related to bank size affect covered bond pricing: 1) large banks tend to issue covered bonds more frequently and in larger amounts, resulting in better secondary market liquidity (and hence lower liquidity risk premia); and 2) large banks often have a higher credit rating.

With regard to the statement of the consultation document that “covered bonds became as a whole a ‘too big to fail’ market, regardless of the systemic nature of individual issuers”, the experience of the crisis showed that governments have prevented defaults of certain covered bonds through the bail-out of their issuers. Under the new bail-in rules included in the Bank Recovery and Resolution Directive (2014/59/EU) (BRRD) this will change in the future, although covered bonds are specifically excluded from bail-in under the BRRD (up to the collateralised part only).

The location of the issuer is intrinsically linked to the issuer’s lending operations and therefore to the composition and quality of the cover pool. Moreover, geographic location affects the credit rating of the issuer and the covered bonds through the credit rating of the sovereign.

Is there an appropriate alignment in the regulatory treatment between covered bonds and other collateralised instruments? If there is a misalignment, could you illustrate what differences in regulatory treatment you deem as inappropriate and why?

The ECB considers it important that the overall regulatory treatment of covered bonds (i.e. CRR, LCR, Solvency II, including due diligence, transparency and reporting) should reflect their unique features, but also their similarities with close substitutes, such that an appropriate level playing field is maintained. Although the ECB considers the regulatory treatment of covered bonds under Article 129 CRR to be prudent overall and consistent with the resilience of covered bonds historically, it is worthwhile exploring options to increase the risk-sensitivity of covered bond prudential treatment, including with a view to providing the option of reducing reliance on ratings from credit rating agencies. Such options could include looking at, for example, the segregation and quality of the cover pool, the quality of the issuer, or mitigants to liquidity or operational risks, including the regulatory status of duly constituted cover pools in the case of issuer insolvency and greater transparency to enable market participants to perform due diligence on covered bonds. In addition, the appropriateness of preferential risk weight treatment should be monitored on an ongoing basis, including in the light of continuous innovation within the covered bond asset class, like, for example, a more pronounced usage of non-standard amortisation structures, such as conditional pass-through covered bonds.

3. Exploring the case for a more integrated framework

Would a more integrated "EU covered bond framework" based on sound principles and best market practices be able to deliver the benefits suggested in section 2 of Part II? Are there any advantages or disadvantages to this initiative other than those described in section 2 of Part II?

The ECB agrees with the Commission's analysis regarding the advantages and disadvantages of the harmonisation initiative in respect of the covered bond market. The potential benefits of a more integrated covered bond market in the EU are well described in the consultation document. The covered bond market is one of the largest private debt markets in Europe and an important source of long-term financing. Covered bonds have proved overall to be a resilient funding tool, including during the financial crisis. As part of developing a capital markets union in the EU, harmonisation of the covered bond market in the EU is warranted.

In your view, are market-led initiatives such as the "Covered Bond Label" sufficient to better integrate covered bond markets? Should they be complemented with legislative measures at Union or Member State level?

Market-led initiatives, such as the ECBC's Covered Bond Label and the transparency initiative by the Covered Bond Investor Council (CBIC) are welcome initiatives which have helped to spur and focus discussion among issuers and investors on the appropriate disclosure regime for covered bonds. In particular, the ECBC's Covered Bond Label has contributed to a more integrated covered bond market in the EU by providing investors with a quantitative comparison tool for covered bond programmes and issuers. This has been complemented by the introduction of a common Harmonised Transparency Template (HTT). This template requires more information on both the cover pool and the programme structure than is currently required by Article 129 CRR (see also the section below on transparency). However, issuers of covered bonds are not required to follow these initiatives, since compliance is on a voluntary basis. If an issuer wants to obtain the Covered Bond Label, it has to comply with the criteria, which is done on a self-certification basis. In the ECB's view, market-led initiatives could provide useful inputs, but may not achieve the necessary convergence alone, because they are only implemented on a voluntary basis and tend to converge towards lowest common denominator standards, which are generally insufficient.

Should the Commission pursue a policy of further legal/regulatory convergence in relation to covered bonds as a means to enhance standards and promote market integration?

The ECB is in favour of a high quality and transparent covered bond market and sees potential for harmonisation of some standards and practices across the EU. In particular, national covered bond frameworks are heterogeneous in terms of the pool composition, the valuation practices, LTV measurement and related limits, and OC levels and measurement. Importantly, any harmonisation under EU law should reflect the highest standards under national covered bond legislation, but caution needs to be applied so as to allow domestic market specificities (where this would not endanger the objective of having a common framework that facilitates cross-border covered bond comparisons and market activity).

Is the suggested list of high level elements for an EU covered bond framework sufficiently comprehensive? Should the Commission seek to develop all the elements or a subset of them?

The ECB concurs with the Commission on the high-level elements for an EU covered bond framework. In particular, the ECB considers the standardisation of the disclosure requirements to be of particular importance.

What are your views on the merits described under section 3 of Part II of using different legal instruments to develop an EU covered bond framework? In particular, would it be desirable to harmonise through a directive some of the legal features of covered bonds and requirements applicable to them under Member States' laws? If it were proposed, how could a 29th Regime on covered bonds be designed to provide an attractive alternative to existing national laws?

Regarding enhancements to the legal/regulatory framework underpinning the EU covered bond market, as pointed out by the Commission, various options may be considered for achieving these goals. One approach (Option 1) would be to support non-binding, market-led initiatives. In the ECB's view, this would provide useful inputs, but may not achieve the necessary convergence, since these initiatives are only implemented on a voluntary basis. Another more robust approach would be to provide for enhancements to the covered bond frameworks at the EU level. This approach has two variants. One variant (Option 2a) envisages enhancements to the covered bond framework that would promote further harmonisation of national regimes by means of introducing additional prudential and/or product-related requirements in Article 129 CRR and/or Article 54(2) UCITS (as well as relevant provisions in the Solvency II Directive). A second variant (Option 2b) is to establish a comprehensive covered bond legal framework ("29th Regime") stipulating high standards. The latter stand-alone framework could initially co-exist with or potentially replace national legal frameworks over time. Although the ECB acknowledges that this would still allow investors from third countries to invest in covered bond products that do not meet the requirements of Article 129 CRR, it considers that the relative importance of EU issuers and investors in the covered bond universe would ensure sufficient convergence.

The ECB agrees with the Commission that a 29th Regime may stimulate a more integrated covered bond market in the EU, but it could also increase fragmentation by introducing yet another covered bond model. Moreover, such a regime would need to provide issuers with significant incentives to move to this new comprehensive EU framework. Despite the differences in the various national covered bond frameworks, the covered bond market as it is currently structured is generally deemed well-performing. Building an EU regime stipulating high standards in the sense of a 29th Regime standing next to or overriding national law would be a resource-intensive and complex legal initiative.

The ECB therefore sees merit in the notion of a comprehensive covered bond legal framework over a medium to long-term horizon, following a harmonisation and convergence process based on a dedicated covered bond legal framework. The ECB is of the view that further harmonisation achieved through such a convergence process would be desirable and beneficial for covered bond markets. The ECB therefore sees merit in starting with Option 2a, which could over a medium to long-term horizon converge into Option 2b.

How should an EU covered bond framework deal with legacy transactions?

Given the importance of the EU covered bond market, the potential transition to a new comprehensive covered bond framework or strengthened national frameworks should encompass a sufficiently long transition period with appropriate grandfathering provisions.

Would you view a combination of recommendations to Member States (Option 1) and targeted harmonisation of certain minimum standards (Option 2) as desirable and sufficiently flexible?

As outlined above, Option 1 would, in the ECB's view, provide useful inputs, but may not achieve the necessary convergence since, non-binding, market-led initiatives are only implemented on a voluntary basis. The ECB sees merit in pursuing further harmonisation by means of introducing additional prudential and/or product-related requirements in Article 129 CRR and/or Article 54(2) UCITS (as well as relevant provisions in the Solvency II Directive). Considering the extent of fragmentation of national covered bond frameworks, and the need for effective supervision of the implementation of a harmonised approach, the ECB sees merit in the notion of a comprehensive covered bond legal framework over a medium to long-term horizon, following a harmonisation and convergence process based on a dedicated covered bond legal framework. The ECB is of the view that further harmonisation achieved through such a convergence process would be desirable and beneficial for covered bond markets. The ECB therefore sees merit in starting with Option 2a, which could over a medium to long-term horizon converge into Option 2b.

4. Covered bond definition

The ECB welcomes the Commission's proposal to define regulated covered bonds and to extend the covered bond definition currently in place in Article 52(4) of the UCITS Directive. As regards the idea of extending the UCITS definition to include covered bond issuers established in third countries (i.e. non-EEA countries), the ECB notes that the applicable legal and regulatory regimes would need to be assessed by the Commission as being equivalent to the EU framework, in particular as regards insolvency remoteness and the dual recourse feature in the case of issuer default. This might be challenging. Moreover, national insolvency regimes and enforcement procedures may differ substantially. Efforts to assess third country frameworks and programmes may not be as crucial, given that EU jurisdictions dominate global covered bond issuances and volumes outstanding (around 85% stems from EU jurisdictions). The proposal to have non-EEA frameworks monitored and updated by the European Securities and Markets Authority (ESMA) or the EBA, ensuring that inter alia adequate enforcement measures are in place concerning cover assets, is appropriate. As an alternative to the proposed definition, the ECB considers that additional product-related requirements could be used in Article 52(4) UCITS in order to further define covered bonds in Europe.

The ECB also welcomes the idea of a system operated by either the ESMA or the EBA listing all qualifying instruments that comply with the potential new EU framework.

5. Covered bonds and the system of public supervision

ISSUER MODELS AND LICENSING REQUIREMENTS. ROLE OF SPVs ONGOING SUPERVISION AND COVER POOL MONITORING (PRE-INSOLVENCY)

Should the current licensing system be simplified to require a "one-off" authorisation only for all covered bond issuers based on common high level standards? What specific prudential requirements (that is, in addition to those in CRR and CRD) could be applied as a condition for granting a covered bond issuer license?

If the covered bond issuer is subject to a one-off covered bond-specific licence, what would be the additional benefits of requiring that each covered bond programme be subject to prior authorisation as well? Alternatively, would pre or post notification to the competent authority of the programme and of each issue within or amendment to the programme suffice?

How should "covered bond programme" be defined for these purposes?

Where the issuer of pooled covered bonds is an SPV, should this issuer be regulated as a credit institution or some other form of legal entity? Should the cover pool be incorporated as a regulated entity? Who should be the

supervisory authority for these purposes, the competent authority or the resolution authority? What are your views on the proposals set out in subsection 3.3 of Part III on the appointment and legal regime for a cover pool special administrator? Should the special administrator be obliged to report regularly to the relevant supervisory authority? Should the content and regulatory [sic] of such reporting be the same as for the issuer?

There is no unique model of authorisation/licensing of covered bonds issuers, and more than one set-up might be allowed. In this respect, the ECB believes that full harmonisation on issuance models is not necessarily the most appropriate way to achieve the desired level of equivalence between covered bonds frameworks with regard to cover pool monitoring and ongoing supervision. A principles-based approach could be more appropriate, taking into account the specificities of each legal regime.

The licensing process should always be in line with certain principles:

- There should be at least an ex ante licensing process for the issuing institution to ensure that the issuer has the operational capacity and expertise, and has developed appropriate internal processes and procedures, to manage cover pools and bond issuances on an ongoing basis;
- Whether covered bond issuers are specialised institutions or are also authorised as credit institutions, they should be subject to a separate licensing process for their covered bond activities, which have features that are distinct from those of regular banking activities;
- All prudential requirements that have led to the authorisation being granted should be monitored regularly by a competent authority to ensure ongoing compliance;
- This competent authority should have well-defined supervisory competences and powers to enforce its decisions and, notably, to impose measures on institutions that are in breach of the terms of their licence;
- The licensing process should cover the entire life of the issuer and should contain provisions to account for the resolution/insolvency of the issuer.
- The licensing process should be accompanied by ex ante approval at programme level to ensure that requirements and rules established by the covered bond framework are correctly implemented.

Provided that the above-mentioned principles are met, an ex ante approval or notification process at issuance level does not seem warranted. So long as the requirements of the covered bonds regime are established in a sufficiently precise and clear manner that it does not require individual assessment, an issuance notification should be sufficient.

In your view, would it be desirable for an EU covered bond Framework to set common duties and powers on competent authorities for the supervision of covered bond programmes and issuers? What specific duties and powers should be included in the Framework and/or EBA or ESMA Guidelines? What are your views on the proposals set out in subsection 2.2 of Part III on the appointment of and legal regime for cover pool monitors?

The supervision of covered bond issuers should be supplemented by cover pool monitoring organised on a continuous basis. To this end, a covered bond framework should include cover pool monitors. While different arrangements are possible, the role of cover pool monitor should comply with some principles:

- The eligibility, duties and tasks of cover pool monitors should be clearly defined in the covered bond framework.
- To prevent conflicts of interests, the cover pool monitor should be distinct from the regular external and internal monitors of the issuer, and should be independent of the issuer.
- Cover pool monitors should be distinct from, but report to, the competent authority.
- Cover pool monitors should be appointed by, or at least confirmed by, the competent authority.
- Cover pool monitors should always inform the competent authority of their findings in a timely manner.
- Cover pool monitors should have direct and continuous access to the covered bond issuer and to all relevant information they might need to perform their duties, in particular information related to the monitored cover pool.

In accordance with the EBA report (recommendation 7-A), the supervision of covered bond issuers should be supplemented by cover pool monitoring organised on a continuous basis, unless this monitoring is directly exercised by the competent authority itself.

Should the ECB have specific supervisory powers?

Article 127(6) of the Treaty allows the Council, acting unanimously, and after consulting the European Parliament and the ECB, to confer specific tasks upon the ECB concerning policies relating to the prudential supervision of credit institutions and other financial institutions with the exception of insurance undertakings. Accordingly, the SSM Regulation, in particular Articles 4(1) and 5, confer on the ECB specific tasks concerning policies relating to the prudential supervision of credit institutions, with a view to contributing to the safety and soundness of credit institutions and the stability of the financial system within the Union and each Member State.

The ECB agrees that the current tasks conferred on the ECB by the SSM Regulation do not include the supervision of a dedicated covered bond framework at the national level.[2] The ECB could exercise supervisory powers within the potential future covered bonds framework only to the extent that such powers are necessary for carrying out the prudential tasks conferred on the ECB under the SSM Regulation.

In line with the tasks currently conferred by the SSM Regulation, such powers could include supervision of any rules that credit institutions supervised by the ECB have to comply with as investors to manage risks arising from the covered bonds, including risk weights assigned, investor due diligence, risk management processes and treatment of covered bonds for liquidity purposes. Where the credit institutions supervised by the ECB are issuers of covered bonds, the ECB could exercise supervisory powers which ensure the soundness of the credit, operational and reputational risk management arising from the transactions as well as the impact of the transactions in respect of asset encumbrance and related liquidity risks.

On the other hand, under the current text of the SSM Regulation, the ECB is not and cannot be assigned non-prudential tasks and powers in relation to the supervision of non-prudential rules on covered bonds. Such rules would include requirements for issuers that are specifically concerned with the design and characteristics of products and investor protection.

Looking beyond the legal obstacles to the transfer of supervisory competences to the ECB in the area of covered bond issuance, it appears that the potential benefits that could be reaped from the harmonisation of national covered bond legal frameworks are much more significant at this stage than those from the direct supervision of covered bond issuances.

In the light of the historical robustness of existing covered bonds regimes, NCAs are in a better position to carry out product supervision owing to their relevant experience, as the supervision of covered bond issuers requires very specific expertise and knowledge of the respective national framework that differs from those usually required to supervise credit institutions. At this stage, the potential value added of direct supervision of covered bond products does not seem to clearly outweigh the associated costs.

Moreover, the ECB performs the prudential supervision of euro area significant institutions, and any legislative framework on covered bonds should be applicable EU-wide in order to be consistent with the Single Market and the CMU. Therefore any specific role for the ECB in the supervision of credit institutions as covered bond issuers would be limited in scope to the tasks already conferred by the SSM Regulation and to the credit institutions already subject to its supervision. However, NCAs responsible for the supervision of covered bonds should cooperate with the ECB as a prudential supervisor.

[2] As described in the EBA report, the following aspects of supervisory practices related to the issuance of covered bonds in national jurisdictions are considered within the supervision of covered bonds: (i) supervision of issuers prior to the issuance; (ii) ongoing supervision of covered bonds issuance; (iii) supervision post-default of the issuer; and (iv) operational aspects of covered bond supervision.

6. Dual recourse and insolvency/resolution regime

Do you agree with the proposed formulation for "dual recourse"?

"*… the Framework could provide that 'regulated' covered bonds must grant the bondholder:*

- ***a direct claim against the cover pool on an absolute priority basis upon default of the issuer. 'Absolute priority basis' means that the proceeds from the cover pool must be applied to repay principal and interests due to bondholders in priority to all other creditors of the issuer. The issuer's default may be triggered upon its resolution or declaration of insolvency; and***
- ***a full recourse claim against the issuer for the timely repayment of principal and payment of interests attached to the covered bonds. 'Full recourse' means that bondholders must be entitled to the proceeds from the liquidation of the issuer's insolvent estate as 'unsecured creditors' for any deficit that may result from applying the proceeds of the cover pool to meet all liabilities due to them on an absolute priority basis as set out above*."**

The concept of dual recourse is at the core of a covered bond and it is included in the list of features in **Article 52(4) of the UCITS Directive**[3]: "*sums deriving from the issue of those bonds shall be invested in accordance with the law in assets which, during the whole period of validity of the bonds, are capable of covering claims attaching to the bonds and which, in the event of failure of the issuer, would be used on a priority basis for the reimbursement of the principal and payment of the accrued interest*".

Both the Commission's and the EBA's proposed formulations of the dual recourse concept are more detailed than that of Article 52(4). Neither the Commission nor the EBA's report[4] suggest that these more detailed formulations are designed to address any actual or perceived deficiency in the dual recourse mechanisms of the various covered bond regimes in EU Member States. Rather, the ECB understands that the intention is merely to provide a more precise and elaborated description of the function and operation of dual recourse. On this basis, the ECB agrees in principle with the Commission's proposed formulation, as it captures the essence of dual recourse, i.e. a priority claim on the assets in the cover pool and a full recourse claim against the issuer in the event of issuer default. The ECB nonetheless suggests the adjustments set out below to the Commission's proposal in line with the overall approach of promoting a level playing field in the EU.

First, the *manner* in which the cover pool assets are held for the benefit of the bondholders is not essential to the dual recourse mechanism. Rather the bondholders' claims to the proceeds of the cover pool assets must simply have

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3 Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) (OJ L 302, 17.11.2009, p. 32).

4 The EBA's Report on EU Covered Bond Frameworks and Capital Treatment, 1 July 2014, p. 23.

priority over those of other creditors. In order not to prejudice any jurisdiction in which bondholders' claims to either the proceeds or the assets themselves may be characterised as more direct or less direct than in another jurisdiction, it is proposed to delete the reference to a "direct" claim. Furthermore, it is suggested that the reference to an "absolute priority basis" be changed to a reference to a "priority basis" in order to not to prescribe a particular ranking of bondholders and other creditors, such as cover pool administrators, and to leave this either to national covered bond frameworks or to EBA recommendations.

Second, the ECB suggests deleting the reference to examples of when the issuer's default may be triggered. Events of default are typically adjusted to refer in a bespoke manner to jurisdiction-specific legal proceedings under the relevant EU Member State's national restructuring, insolvency and resolution laws and may extend beyond the examples set out in the Commission's proposal. Events of default under covered bonds would, in our experience, also include non-payment of the redemption amounts on the final maturity date of the covered bond. In order to avoid either limiting jurisdiction-specific events of default or failing to capture common events of default such as non-payment, the ECB suggests simply referring to "default of the issuer" without further elaboration.

Third, the ECB found the EBA's reference to the pari passu ranking of covered bondholders' claims with other unsecured creditors useful and suggests it should be incorporated in the Commission's proposal for the Framework. The claim as an unsecured creditor to "any deficit" could also be clarified as limited to the extent of that deficit.

Finally, the ECB suggests (a) that references to the "cover pool" should be clarified by referring to "assets included in the cover pool" wherever this is more accurate and (b) that references should be made to "payment" rather than "repayment" of principal and to "interest due under the covered bonds" rather than "interests attached to the covered bonds".

The ECB's proposed amendments

"… the Framework could provide that 'regulated' covered bonds must grant the bondholder:

- a ~~direct~~ claim against the **assets included in the** cover pool on a priority basis upon default of the issuer. '~~Absolute p~~**P**riority basis' means that the proceeds from the **assets included in the** cover pool must be applied to ~~re~~pay principal and interest~~s~~ due to bondholders in priority to ~~all~~ other creditors of the issuer~~.~~ ~~The issuer's default may be triggered upon its resolution or declaration of insolvency~~; and
- a full recourse claim against the issuer for the timely ~~re~~payment of principal and ~~payment of~~ interest~~s~~ ~~attached~~ ~~to~~ **due under** the covered bonds. 'Full recourse' means that bondholders must be entitled to the proceeds from the liquidation of the issuer's insolvent estate **on a pari passu basis with** ~~as~~ **the issuer's** 'unsecured creditors' ~~for~~ **to the extent of** any deficit that may result from applying the proceeds of **the assets included in** the cover pool to **pay all amounts** ~~meet all liabilities~~ due to them on an ~~absolute~~ priority basis as set out above."

Are there any advantages to using an SPV as an additional segregation mechanism at issuance?

In the ECB's view, the effectiveness of dual recourse as relevant for the cover pool, i.e. bondholders' claims against the assets included in the cover pool on a priority basis upon default of the issuer, depends first on the capacity to identify which assets form part of the cover pool and are therefore subject to different treatment to other assets of the issuer.[5]

The second key safeguard for the priority of covered bondholders' claims is to ensure that, once identifiable, the assets can and will continue to be administered independently of the issuer's other assets. "Segregation" of the cover pool assets from the other assets of the issuer assists this independent administration, as a full legal transfer of cover pool assets to a separate legal entity such as an SPV (in the Netherlands, the United Kingdom and Italy) can achieve a clear "segregation" of the assets from the issuer's balance sheet. However, the ongoing transfer and substitution of assets could be more administratively burdensome and require ongoing compliance with legal formalities of transfer, thereby giving rise to greater costs for issuers. In addition, the full transfer of cover pool assets does not automatically address the two issues of asset identification and effective independent administration; rather these aspects need to be provided for separately, even in the case of a legal transfer of assets to an SPV. On this basis, the ECB recognises that the use of an SPV could in theory support "segregation" in a broad sense, but it does not view it as essential or necessarily protecting the priority claim of covered bondholders in a superior manner to other covered bond models where no transfer of assets occurs. Rather, frameworks which make clear provision for procedures to ensure asset identification and effective independent administration appear better suited to achieving the goal of protecting the bondholders' priority claim, regardless of the "segregation" method. The ECB therefore views the incorporation of measures or best practices designed to enhance asset identification and effective independent administration as more useful than a prescribed method of asset transfer.

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5 In this sense, the ECB agrees with EBA's observation that "[a]s the issuer of the covered bonds enters default ensuring that the cover assets can be identified is crucial for the realisation of the covered bond investor's preferential claim over the cover assets" (the EBA's Report on EU Covered Bond Frameworks and Capital Treatment, 1 July 2014, p. 23).

Do you agree with the suggested ranking for cover pool liabilities? What are your views on the proposals on the appointment and legal regime for a cover pool special administrator?
Should the Framework provide for a cut-off mechanism and, in particular, should such a cut-off mechanism (a) preclude the closure of insolvency or resolution before possible residual claims from the covered bondholders against the issuer or the insolvent estate have been identified and quantified; (b) set out clear and objective requirements on the valuation of the cover pool and the timing for such valuation; (c) extinguish the residual claim on the estate or the successor credit institutions after sufficient assets have been segregated for the benefit of covered bondholders at the outset of the resolution or insolvency proceedings; and (d) give specific powers and duties to the resolution authority and, if so, what should those consist in?

The ECB agrees with the principle that the ranking of claims should be consistent pre- and post-resolution/insolvency in order to ensure certainty for the investors, and considers that the provisions contained in the BRRD applicable to the resolution of covered bond issuers should be implemented and tested.

Moreover, the ECB notes that, following the initiation of resolution proceedings against the issuer, it may be feasible, if needed, for the resolution authority to initiate the transfer of both the cover pool of assets and associated liabilities to bondholders to another covered bond issuer/specialised credit institution or a bridge bank, guided by the resolution plan of the issuer. As covered bond documentation may provide for certain rights in the event of default (such as the initiation of resolution/insolvency proceedings against the issuer), it is important that the legal framework stipulates that resolution/insolvency of the issuer does not automatically accelerate the payment obligations towards bondholders.

Once insolvency proceedings have been commenced against the issuer, a special administrator for the cover pool may be appointed by the courts on the recommendation of the resolution authority of the issuer to protect the interests of bondholders. The cover pool would be administered by the special administrator as a "special part" of the issuer (but not necessarily as a separate legal entity) distinct from the insolvency estate. To the extent feasible in the covered bond structure, the ECB recommends that the special administrator of the cover pool is not the same person as the administrator of the insolvent estate in order to avoid potential conflicts of interest.

While preparations for resolution are underway at the resolution authority, including an independent valuation of the assets in the cover pool to determine any potential excess/shortfall, adequate liquidity is needed to meet regular payments to bondholders, primarily drawing on covered bond liquidity buffers. In such a valuation exercise – e.g. under Article 36 BRRD or Article 20 of the Single Resolution Mechanism Regulation (SRMR) – a forward looking assessment is needed to ascertain whether sufficient assets are available in the cover pool (including those assets representing regulatory and voluntary over-collateralisation) to meet future payments to bondholders. Only to the extent that there are excess assets above this threshold (i.e. assets that are not needed to meet future payments to bondholders) can assets contribute to loss absorption and be released to the entity in resolution/insolvent estate. The ECB notes that where a deficiency claim has been lodged in the proceedings against the issuer, any such unsecured claim may be subject to bail-in in resolution (see Article 44 BRRD).

Where liquidity is insufficient, cover pool assets may need to be liquidated. If this is done under fire-sale conditions, there is a risk of significant destruction of value, which may result in unpredictable and potentially higher residual claims. As a consequence, if a transfer of both the cover pool of assets and associated liabilities to bondholders to another covered bond issuer cannot be achieved, and extending payments to bondholders might introduce uncertainty, the ECB sees merit in establishing a clear cut-off mechanism in the legal framework. The aim would be to preserve as much value as possible and reduce the risk of large deficiency claims crowding out other unsecured creditors. In such a cut-off regime, any potential shortfall in the cover pool of assets would be ascertained and entered as an unsecured claim against the entity on a pari passu basis with other unsecured creditors. Thereafter, the entity would be released from further residual claims after a given date and assets could be assigned to an asset manager for further management on behalf and for the benefit of the bondholders.

The ECB agrees that independent valuation of the cover pool assets in resolution/insolvency is important and should be carried out at appropriate intervals and according to valuation standards set out in the legal framework (i.e. Article 36 BRRD or Article 20 SRMR). In resolution, the resolution authority will appoint a qualified and independent valuation expert for this purpose. For insolvency proceedings, the resolution authority should propose an expert for appointment by the court.

The consultation paper mentions two scenarios (excess collateral of the cover pool and residual claim against the issuer) that assume that a settlement of the cover pool is possible within a relatively short period of time. The ECB notes that, in practice, assets in the cover pool may have rather long maturities. In the absence of a transfer of the cover pool to another covered bond issuer, this may entail a longer settlement process. Also, the ECB suggests removing some ambiguity in the wording of question (c) above. Once resolution/insolvency proceedings have been commenced against the issuer, it would not seem appropriate to allocate additional collateral ("sufficient assets") to the cover pool, as any shortfall in the value of the assets normally results in an unsecured claim against the insolvency estate, rather than the creation of additional security. Appropriate provisions should be made for such unsecured claims in the administration of the insolvency estate of the issuer in line with the treatment of other unsecured claims on a pari passu basis.

7. The cover pool

Do you agree with the proposed definitions for "residential" and commercial loans" as cover assets?

The ECB concurs with the Commission on the definitions for residential and commercial loans.

Should certain riskier residential or commercial loans (i.e. buy-to-let mortgages; second home loans; loans to real estate developers; etc.) be excluded from the cover pool or permitted subject to stricter criteria?

A robust covered bond model should be shielded against riskier assets such as buy-to-let mortgages and loans to real estate developers. Moreover it is important to establish a clear distinction in the covered bond legal/regulatory framework between "prime" residential loans and other forms of residential loans. It would appear sensible that "prime" residential loans (as defined for covered bond purposes) should not involve buy-to-let loans, second home loans, loans to real estate developers, or lower-ranking liens where the first lien is not included in the cover pool. In addition, the ECB welcomes the exclusion of non-performing loans from the cover pool. The Commission is also urged to examine harmonised approaches/procedures for removing from cover pools loans that were performing at the point of inclusion but subsequently cease to be performing.

In relation to LTVs, what are your views on the proposals set out in subsection 4.1 of Part III on minimum LTVs?

The ECB agrees with the key common features mentioned in subsection 4.1 of Part III on minimum LTVs. Similar to current rules in the CRR, the legal/regulatory framework should include a substantial differential in the LTV limit between residential and other loans to reflect the difference in risk. Set LTV limits could either be used for the calculation of the over-collateralisation (with the part in excess of the cap being excluded, i.e. a "soft" LTV limit) or as an eligibility criteria applied at inception and on an ongoing basis (i.e. a "hard" LTV limit). In addition, further harmonisation on the calculation of LTVs themselves, and EU guidelines specifying the measures to be enforced and reported for covered bonds, would help to facilitate cross-border comparability of covered bond products. Even if this would take time for issuers to achieve, the process should not be delayed. For example, set LTV limits should be applied over the entire lifetime of the covered bonds, while the valuation should be updated periodically (see below) and the current balance of the loan could be used (instead of the original balance). In the case of any excess over the LTV limit, it is important that the covered bondholder has priority benefit of the excess in the event of the liquidation of the cover pool.

In the case of insured properties, should higher LTV limits be allowed if the insurance cover meets certain requirements?

Where mortgage loans are fully guaranteed, a higher LTV could be considered, subject to criteria concerning the insurance coverage and provider. Such a higher LTV limit should only be considered if the national law of the Member State in which the loans were originated provides clear LTI limits on the amount that an obligor may borrow.

In what other cases should higher LTV limits be allowed?

In other circumstances, higher LTV limits should not be allowed.

Could loan-to-income requirements be used to replace or complement LTV limits?

LTI ratios are a rough measure of a borrower's ability to pay, whereas LTV ratios proxy a borrower's willingness to pay. The two concepts are therefore complementary when assessing loans. The introduction of a supplementary LTI ratio as an indicator of the creditworthiness of the borrower will be supported by the implementation of the Mortgage Credit Directive (Directive 2014/17/EU)[6]. Therefore, an LTI ratio requirement at issuance of the mortgage could complement LTV limits, but should not replace LTV limits. LTI requirements should especially be considered where soft LTV limits are to be used. It is important to ensure that, in the case of residential mortgage loans, the information provided by the borrower (on income and employment) is verified by the lender (i.e. no self-certification). The covered bond issuer should provide a representation that borrower information, especially information on income, has been verified.

Should there be an additional average LTV eligibility limit at portfolio level?

An additional average LTV limit at the portfolio level could be considered in the case of soft LTV limits.

Should LTV limits be used to determine: eligibility (loan in/out) of loans at inception; eligibility (loan in/out) of loans on an ongoing basis; simply contribution to coverage?

Set LTV limits could either be used for the calculation of the over-collateralisation, with the part in excess of the cap being excluded ("soft" LTV limit), or as an eligibility criteria applied at inception and on an ongoing basis ("hard" LTV limit). Set LTV limits should be applied over the entire lifetime of the covered bonds, and the valuation needs to be updated periodically (see below).

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6 Directive 2014/17/EU of the European Parliament and of the Council of 4 February 2014 on credit agreements for consumers relating to residential immovable property and amending Directives 2008/48/EC and 2013/36/EU and Regulation (EU) No 1093/2010.

In relation to the valuation of cover assets, how frequently should the value be updated and in which way (revaluation, update of the initial valuation, and in which way)?

Valuations should be updated at least on an annual basis (national or regional house price indices could be used). It should be made transparent how the indexation has been conducted and which index was used. For valuations exceeding a certain threshold, in addition to the indexation, a new valuation should be conducted periodically. Covered bond supervision should cover the revaluation practices of the covered bond issuer.

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

Nationally recognised valuation best practices should be accommodated when formulating the criteria. The general principle should be that each mortgage asset is valued by an independent qualified valuer or surveyor (independent of the lender), and a valuation report should be provided which should not be older than 12 months on the date of the mortgage application of the relevant borrower, unless the nationally recognised valuation best practices are different. The covered bond issuer should provide a representation that the valuation has been conducted in line with Article 229(1) CRR or nationally recognised valuation best practices. Covered bond supervision should cover the valuation practices of the covered bond issuer.

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

The ECB welcomes the adoption of the definition of “non-performing exposures” as set out in the EBA’s draft Implementing Technical Standards on supervisory reporting on forbearance and non-performing exposures.

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

The ECB takes note of the EBA’s prudential concerns in relation to the use of RMBSs and/or CMBSs in cover pools. Asset-backed securities (ABSs), such as RMBSs and CMBSs, and also covered bonds, should each not be eligible for the cover pool (no “covered bonds of covered bonds”), as their inclusion adds an additional layer of complexity and opacity to covered bonds.

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

Public sector loans are an important cover asset in EU covered bonds. However, the term “public-sector” can refer to many different entities, such as central governments, development agencies, local hospitals, or wind-down entities and “bad banks”. Moreover, “public sector loans” may be collateralised, uncollateralised, or guaranteed (implicitly or explicitly). Indeed, from a high-level perspective, public sector loans appear to be as heterogeneous as SME loans, given the need to understand any implicit or explicit guarantee arrangements and links with broader public sector finances. These are important factors to bear in mind when considering how to provide sufficient clarity for investors regarding the types of public sector assets backing a cover pool.[7]

The proposed definition set out in the consultation document is similar, but not identical, to the current definition in the CRR. The ECB notes that the term “third country” is applied to jurisdictions outside the EEA in the proposed definition, compared with the meaning of outside the EU that currently prevails in the CRR. For the same reason as given above concerning the definition of covered bonds, the ECB remains cautious about allowing the inclusion of non-EEA public sector loans.

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

This is a complex topic for which further investigation should be conducted in addition to this consultation. However, high-level eligibility requirements could include that the guarantee be explicit, irrevocable, and unconditional. Further details on these terms could be:

1. A guarantee could be deemed explicit if it is explained somewhere, for example in the specific loan terms or, as regards covered bonds, in the representations and warranties for the overall cover pool.
2. A guarantee could be deemed irrevocable if the guarantee cannot be removed, i.e. grandfathering exists for all loans guaranteed by the guarantor.
3. A guarantee could be deemed unconditional if the lender can claim the principal and interest directly from the guarantor without any conditions attached.

Additional potential criteria could include the type of guarantor (to exclude excessively close links between the guarantor and the guaranteed entity) or whether the guarantee is payable on first demand or not. With the latter feature, the guarantor

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[7] In this regard it is noteworthy that Fitch, S&P, and Moody’s all require highly-detailed information on public sector assets when rating covered bonds including these claims. See also the section below on transparency for further discussion.

must provide interest/redemption payments immediately upon the investor's first request ("on first demand").

Should the Framework exclude aircraft, ship and SME loans from cover pools or should they be allowed only subject to strict criteria and limits?

One of the generally-accepted premises with covered bonds is that only prime assets from banks' balance sheets are used as underlying assets in the cover pool. In addition, the issuance of covered bonds was traditionally aimed at financing only a part of an issuer's balance sheet. These are important reasons for the success of covered bonds over the years and their resilience during the financial crisis. In this respect, both mortgage loans and public sector loans are considered prime assets. In assessing whether SME loans may be included in a cover pool under a legislative covered bond framework in the future, however, a thorough analysis would be useful in order not to jeopardise one of the fundamental aspects of covered bonds, i.e. the inclusion of only prime balance sheet assets. It is generally acknowledged that SME loans are more heterogeneous in nature.

The ECB shares the prudential concerns expressed by the EBA and finds it appropriate to remain prudent regarding loans secured by aircraft and to exclude loans secured by ships from the preferential risk weight treatment under Article 129 CRR.

However, this does not preclude the inclusion in the cover pool of derivatives used for the sole purpose of hedging market price risks resulting from the composition of the cover pool, as they could be seen as an integral part of the cover pool.

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

There is no generally accepted way to identify prime SME loans. However, several initiatives are in place that could be valuable in identifying a category of prime SME loans based on SME loan credit quality data, such as a bank's internal loss given default (LGD) estimate, the principal arrears amount and the number of days in principal arrears.[8]

[8] An ongoing, though not yet operational, initiative that would contribute to the identification of credit risks on SME loans in the medium term is the Eurosystem's AnaCredit project (related to Decision ECB/2014/6) with its requirements on the reporting of harmonised and granular data on credit and credit risk by credit institutions. The ECB's draft Regulation on the collection of granular credit and credit risk data relates to both supervisory and central banking functions. The data collected will not be publicly available, but the Regulation will steer banks' processes in compiling these data, making them easily transmissible to commercial data providers or publicly available credit registers.

Another example is the European DataWarehouse (ED), which collects standardised and detailed information on, among other things, Eurosystem eligible ABSs backed by SME loans. Although currently there are few SME loans pledged in cover pools, it is plausible that characteristics of SME loans used in SME ABSs and reported to the ED could be a valuable data source for identifying a prime category of SME loans.

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

In principle, in line with EBA observations, homogeneous pools consisting exclusively of one asset class are preferred. Nevertheless, for residential and commercial loans, mixed pools could be considered, subject to appropriate disclosures and safeguards to ensure that the risk profile of the pool does not materially change over time. A prudent concentration limit in respect of individual obligors should also be established. The ECB notes that further work is required in the light of the current regulatory treatment of mixed pools under Article 129 CRR.

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

On limits on exposures, the ECB finds it prudent to regulate and limit substitute assets according to strict criteria or, alternatively, substitute assets should not be taken into account in the calculation of the coverage requirement, such that risks are instead limited to the cover pool assets.

8. Over-collateralisation

Which option should be preferred for the Framework to formulate the coverage requirement? (nominal coverage; NPV coverage; NPV coverage under stress)

Nominal coverage should be preferred because this is the most effective way to achieve a simple and comparable arrangement. Any coverage requirement other than nominal would be difficult to establish in a credible manner because of the complexity associated with formulating common yet representative yield curves and stress assumptions across multiple jurisdictions, issuers, covered bonds types, and cover pool types.

From another perspective, providing supervisors, investors, rating agencies, and other market participants with sufficient transparency on all the liabilities and the cover pool would enable them to draw their own conclusions in “net present value” (NPV) or “stressed” terms.

In line with this general approach, the ECB also considers that the guidelines to supervisory authorities should specify further how the OC requirement should be implemented and monitored by the authorities competent for the supervision of covered bond issuers. An additional harmonisation of supervisory practices would decisively contribute to strengthening investor confidence in OC levels required under the respective covered bond regimes. The ECB considers that the EBA would be in the best position to develop and adopt such guidelines.

If the coverage requirement were formulated as net-present value coverage under stress, should the stress tests be specified in any form in the Framework or ESMA/EBA regulatory guidelines?
See previous response.

Should derivatives entered into in relation to the cover pool be taken into account for the purpose of determining the coverage requirement?
Derivatives (entered into for the purpose of hedging market risks resulting from the composition of the cover pool and covered bond liability structure) should not be taken into account for the purpose of determining the coverage requirement on the asset side for several reasons. First, the nature of cover pool derivatives is different to that of assets (such as credit claims) providing coverage for the liabilities of the programme. Second, allowing derivatives on the asset side of the coverage requirement presents obvious complexities for any external party trying to adequately assess these instruments. In this respect, derivative counterparties are, in the vast majority of cases, financial institutions or financial entities. Moreover, the valuation of derivative instruments might introduce complexity in the determination of the coverage requirement. Third, this would also be consistent with the rules on ABSs (credit enhancement does not include derivatives). At the same time, where derivative instruments become liabilities (i.e. are “out of the money”), it is important that arrangements exist for the liability side of the coverage requirement to reflect this effective increase in total programme liabilities. Otherwise over-collateralisation levels will be artificially inflated.

What exposures to credit institutions within the pool should be taken into account to determine the coverage requirement and why?
Exposures to credit institutions within the pool should generally not be taken into account in determining the coverage requirement, unless there are strict rules on the type of exposures and where these exposures are held. For example, cash deposited in an account with a non-affiliated credit institution, with strict and enforceable replacement triggers, would appear to be both sufficiently liquid and sufficiently accessible during times of market stress.

This is not to say that liquid assets should not be present to assist with asset-liability mismatches. However, insofar as coverage requirements are concerned, exposures to credit institutions should not be included. This would also help ensure the relative homogeneity of pools and facilitate the credit risk assessment of the cover pool by market participants.

Should a quantitative mandatory minimum OC level be set in the Framework?
An above-zero minimum (nominal) OC level should be explored as, although OC is a relatively blunt buffer, it has the advantage of simplicity for market participants. However, the ECB cautions that such an above-zero minimum OC level is not easy to determine. Indeed, the ECB notes that, although at first glance an above-zero

minimum OC level is seen as an appropriate safeguard for covering against future risks, it is a challenging task to appropriately calibrate this measure in practice because of the different *dynamic* risks involved across covered bond structures, hedging arrangements, cover pool types, cover pool heterogeneity, and broader legal arrangements (e.g. set-off clauses).[9]

In addition, the ECB would like to note that OC is typically regarded as a "catch-all" feature, which helps capture both pool-specific risks and other structural risks, such as servicing continuity and commingling. However, these less pool-specific risks could also be addressed more directly by establishing dedicated arrangements (e.g. back-up servicing arrangements if there is an intra-group servicer) or by holding dedicated reserves (e.g. a commingling reserve).

However, if there is an above-zero minimum OC requirement, it is crucial that it is accompanied by sufficient transparency to enable investors, supervisors, and other market participants to assess the robustness of the covered bond programme under different scenarios and to enable investors to calculate their own "internal OC" requirement (similar to the internal rate of return concept) prior to investing.

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

There should be no exceptions to the requirement – there needs to be a simple rule, otherwise the framework will become complex. The ECB understands that a match funding model would cover interest matching, maturity matching, duration matching, and currency matching. In practice, any exceptions would be too challenging to be properly supervised and enforced in a manner that is also clear to investors and other market participants. Exemptions would undermine some of the main benefits of a comparable and simple OC requirement.

Should the Framework set a maximum level of permitted OC?

The ECB is not in favour of a maximum level of permitted OC. The above-mentioned calibration issues would apply here as well. It would not be easy to calibrate an appropriate level, especially considering the specialised nature of certain covered bond issuers.

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9 As part of its preparation of this response, the ECB performed some numerical investigations to further explore this point, examining nominal OC levels on a quarterly basis between 2009-Q2 and 2015-Q1 inclusive, for a median of 155 Eurosystem-eligible covered bond programmes per quarter. Several findings emerged. First, there was extremely wide dispersion across covered bond programmes, with 25th percentiles closer to 5-10% and 75th percentiles around 70-75%. Second, the median nominal OC was time-varying, steadily rising from 17% in 2009-Q2 to 45% in 2015-Q1, while the dispersion around the median is non-constant (heteroskedasticity). These findings suggest that any "appropriate" above-zero minimum OC level would have to be linked with the economic cycle, funding conditions, monetary policy, bank financial health, alternative sources of funding and of capital release, and other aspects that go beyond covered bond regulation.

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

The framework should provide for the treatment of voluntary OC in the event of insolvency/resolution of the issuer – this is a key concern for investors, issuers and supervisors. It is also important that investors understand the safeguards that are available to them upon the insolvency/resolution of the issuer. This would also help clarify other asset encumbrance concerns of supervisors by establishing a comparable definition of OC.

Issuers have incentives to promise substantial protection to investors and to achieve a target external rating (while still respecting asset encumbrance concerns). It is therefore possible for issuers to provide excessive voluntary OC, thereby giving investors the illusion of safety, but there are no common standards governing the status of this OC upon issuer insolvency/resolution.

Therefore, no matter the amount of OC, the question of its treatment upon the insolvency/resolution of the issuer cannot be solved simply by mandating minimum OC requirements. Further harmonised requirements are necessary to ensure that the degree of protection promised to investors is indeed available upon issuer insolvency/resolution.

Such treatment could include the following: first, to ensure legal certainty, the treatment of OC should be consistent, and, in particular, it should be clarified that voluntary OC shall be used to secure covered bonds. Second, the timing of the liquidation of voluntary OC should be addressed by ensuring that claims by covered bond investors on the voluntary OC are legally privileged, which would be consistent with the dual recourse nature of covered bonds. If the minimum OC is sufficient to repay covered bondholders, voluntary OC could then be "released" and used to repay other creditors.

The ECB would like to point out that, in order to provide additional certainty to investors, it would be beneficial to establish a more formalised corporate governance process on a going concern basis regarding any reductions in or changes to "committed OC". For example, bondholder consent above a certain common threshold (excluding any bonds retained by the issuer) should be required before committed OC can be reduced. Further exploration of such provisions would be worthwhile in the context of ensuring that OC levels are adequate to mitigate future market and liquidity risks.

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

The issue is not the adequacy of OC levels to mitigate these risks in the absence of targeted measures – rather that it is extremely challenging for investors to arrive at this conclusion themselves, without relying either on the issuer's assurances (which may be subject to conflicts of interest) or on rating agencies/third-parties (which may also be subject to conflicts of interest if these firms are paid by issuers to provide such an assessment). For example, even if OC amounts are identical across programmes, these may refer to different OC types (nominal, net present value, stressed), different OC commitments (voluntary, committed, legally-required), and to different OC treatment post-insolvency/resolution. There is also the issue of fully assessing market and liquidity risks – based on yield curve assumptions, FX assumptions, and different data disclosure requirements.[10]

For OC to adequately mitigate liquidity risk, a substantial part of the OC should be maintained in liquid assets that can be monetised very easily. To that extent, the definition of liquid assets provided in the LCR, and in particular of level 1 liquid assets (provided that they also meet other covered bond eligibility criteria) could serve as a reference. Issuers of coved bonds should be encouraged to facilitate the availability of a cash-flow model – potentially using third-party software providers' platforms – to allow stress tests to be conducted by investors.

What are your views on the potential provisions on the management of cashflow mismatches suggested in subsection 4.3 of Part III? For investors, do you understand how such cashflow mismatches would be dealt with in practice?

Ideally, these mismatches should be detailed in the base prospectus. In practice though, the handling of mismatches would depend on the seniority of the covered bondholder claims, national bankruptcy laws (if the mismatches occur after issuer insolvency/resolution), and on market funding conditions. Most importantly, the handling would depend on the programme maturity structure (hard bullet, soft bullet, conditional pass-through, etc.) as well as well as on broader mitigating arrangements in place (reliance purely on liquid/substitute assets, or also using a liquidity reserve, commingling reserve, set-off reserve, etc.)

Generally, having detailed asset-specific information would help provide additional reassurance for investors that a sufficient portion of the pool is composed of "liquid"

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10 As part of its preparation of this response, the ECB compared the committed OC with a programme-specific assessment for market and refinancing risks in 3,144 programme surveillance reports (roughly 160 programmes per quarter) between 2009-Q4 and 2015-Q1 inclusive. Committed OC was used because, compared with current OC, committed OC appears to be a more reliable measure of the availability of OC to cover future risks. A consistent methodology, to the extent possible, was used to assess these market and refinancing risks. Market risk was defined as the share of the pool mismatch (assets versus liabilities) resulting from adverse interest rate or currency rate movements. Refinancing risk captures the loss on the cover pool assets resulting from discounted sales necessary on the portion of the cover pool exposed to refinancing risk due to asset-liability mismatches. The two measures, which are expressed as a percentage of the cover pool assets, were then added together.

For the majority of programmes, the committed OC was far *below* the assessed market and refinancing risks – the median coverage of committed OC for these risks was 44% across the 3,144 observations. In other words, the median programme had committed OC equal to less than half of the amount necessary to make up for cover pool losses due to market and refinancing risks. Moreover, this was also time-varying: the median committed OC/(market + refinancing risk) ratio was 44% over all observations, but ranged between 22% and 59% on a quarterly basis.

assets. In addition, disclosure on broader mitigating arrangements would be required (e.g. with which entity is the commingling reserve deposited).

Would it be beneficial from your perspective to get systematic information about cashflow mismatches and how these would be managed?

See the above answer on the ability to accurately assess whether OC levels can hedge market and liquidity risks. However, further asset-specific information would be useful to provide reassurance to investors that assets that are claimed to be liquid are indeed liquid. Note that a simple regulatory requirement on substitute assets – for example that these must be LCR level 1 assets – would be insufficient as, during times of market/liquidity stress, investors would need information at the level of the international securities identification number (ISIN).

Moreover, the precise steps and scenarios for handling such mismatches should be spelled out to investors, much like an ABS post-enforcement waterfall.

On the EBA's liquidity buffer recommendation, should covered bond issuers hold a "liquidity buffer" to mitigate liquidity risk in the cover pool?

The ECB considers it important that the legal/regulatory framework envisages the inclusion of a liquidity buffer to cover net outflows from the covered bond programme over a certain period of time. Such a liquidity buffer should also be tailored to reflect extendable maturity features of certain covered bond arrangements (which may call for a different liquidity buffer coverage than "hard bullet" covered bonds).

9. Transparency

What are your views on the current disclosure requirements set out in Article 129(7) of the CRR?

The ECB supports the EBA's analysis in which it is noted that the current transparency requirements in Article 129(7) CRR may leave excessive room for interpretation for both issuers and competent authorities. Article 129(7)'s disclosure requirements are insufficient to allow a sufficient degree of clarity on the health and risks of a covered bond programme, both for investors and for wider covered bond market participants.[11] Among the many arguments to support this, it is telling that both the ECBC's Covered Bond Label and the three major rating agencies all require

[11] Article 129(7) requires at least semi-annual reporting to investing institutions on: (i) the value of the cover pool and outstanding covered bonds; (ii) the geographical distribution and type of cover assets, loan size, interest rate and currency risks; (iii) the maturity structure of cover assets and covered bonds; and (iv) the percentage of loans more than ninety days past due.

substantially more information on both the cover pools and the programme structure than is required by Article 129(7).

If more detailed requirements were preferred, do you agree that issuers should disclose data on the credit, market and liquidity risk characteristics to a more granular level?

The ECB agrees with the view expressed in the Commission's consultation paper, as well as in several market reports, that issuers should disclose data on credit, market, and liquidity risk characteristics with adequate granularity. However, it is equally important to have central access points for the disclosed information. Regardless of whether existing disclosure requirements are extended, it is vital for the entire covered bond market that existing information is available from a centralised location (or several competing centralised locations), as currently there is no single source of information for all of the required elements. There are some very helpful market initiatives, but they are voluntary and do not cover the whole market. Similarly, no rating agency covers the entire universe of EU covered bonds.

If so, what data and to what level of granularity?

A key lesson from the global financial crisis was that investors should be enabled to perform adequate due diligence on their investment opportunities, covering the issuer, the underlying structure, the counterparties involved and the underpinning legal arrangements. Against this background, covered bond transparency should be seen as a way of enabling market participants to investigate covered bonds and to reduce their reliance on rating agencies.

The ECB considers the disclosure of the following sets of data items (grouped by issuer and programme-level information, covered bond liabilities information, and cover pool information) in similar formats and at a regular frequency to be essential:

(i) Essential issuer and programme-level information

- An up-to-date English language base prospectus in order to understand the programme
- Any supplement/notice that amends the conditions of the programme, also in English
- Disclosure of compliance with programme tests (e.g. asset coverage tests)
- Recent published annual and quarterly financial reports of the issuer in English
- Ongoing disclosure of other entities relevant to the covered bond programme (e.g. account bank, swap providers, servicer, back-up servicer, asset monitor)

This information helps investors to understand the programme (including maturity extension procedures, rating triggers, remedy actions, and asset coverage tests), the fulfilment of the programme conditions, and the financial health of the issuer. The information is also important for easy identification, in a standardised format, of all of the associated counterparties. This allows investors in particular to identify linkages that exist both within an individual programme and across covered bond programmes.

(ii) Useful covered bond liabilities information

- A complete and comprehensive list of outstanding covered bonds, including information on the relevant characteristics of these instruments
- The final terms of each series within the programme
- Disclosure of hedging arrangements

This information allows investors to compare the full terms of each individual issuance (outstanding amount, currency, maturity arrangements, interest rate provisions applicable post extension, etc.), and provides reassurance of the robustness of the hedging arrangements under different conditions (e.g. the terms governing a swap).

(iii) Useful cover pool information

- Regular disclosures of information on the cover pool mortgage assets, with a flag indicating whether the issuer considers each asset to be eligible or not and, if partially eligible, to what extent
- Where applicable, the characteristics of each pool transferred and the specific eligibility criteria applied to each
- A detailed list of any substitute assets, including information on the relevant characteristics of these instruments
- A list of definitions used in the reporting and explanations of calculations made for relevant variables (such as LTV), if such definitions are not reported elsewhere
- Performance information on the cover pool, including a history of additions, removals and substitutions of assets in the cover pool

The cover pool information listed above provides reassurance as to the soundness of the collateral backing the cover bonds.

Finally, the ECB is of the view that transparency surrounding processes related to the amendment of covered bonds (via “consent solicitation”) should be enhanced (through, for example, more precise data on voter participation and publication of amended documents) in light of the fact that such amendments are becoming increasingly common and, as highlighted by a number of analysts, a binding decision could in principle be approved by a small minority of bondholders. The ECB therefore believes it would be worthwhile to explore common thresholds for bondholder consent and quorum requirements in the case of amendments of covered bonds, as well as consent fee arrangements that benefit all bondholders following programme amendments.

The ECB acknowledges that covered bonds are different to ABSs; covered bonds contain dual recourse features, whereas ABSs rely on credit enhancement. However, the ECB would also like to highlight several facts worth bearing in mind when determining how much granularity is necessary to allow market participants to assess covered bonds and to monitor their performance.

(i) **Loan-level information on cover pools** has already been required by the three largest rating agencies (Moody's, S&P, and Fitch) for a number of years, both at issuance and on an ongoing basis. This implies that issuers are already able and willing to provide this information.[12] The fact that rating agencies deem loan-level information to be useful for their credit risk analysis and cash-flow modelling, while ordinary investors do not have access to such information, raises interesting questions from the perspective of reducing reliance on rating agencies.

(ii) **Centralised data infrastructure already exists.** The infrastructure required to receive granular cover pool information, in a centralised manner that preserves the anonymity of borrowers and avoids excessive disclosure of the business strategy of issuers, is already available.[13]

(iii) **Required cover pool granularity:** Significant cover pool granularity appears to be required to value covered bonds, in particular given the recent trend towards conversions and issuance of conditional pass-through structures, which require even more attention to be paid to the characteristics of the cover pool.

Should issuers disclose information on the counterparties involved in a covered bond programme?

Yes, see the answer to the question above on the type of information to disclose.

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

The submission of information to investors should be finalised within one month of the interest payment date. This would also help improve the efficiency of the work of third parties, such as rating agencies, who sometimes have to contact issuers on multiple occasions to obtain data submissions. The lack of agreed-upon submission timelines at a regulatory level appears to be leading to inefficiencies and lack of coordination among market participants.

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12 This also suggests that the current arrangement of multiple loan-level templates across rating agencies may be creating unnecessary reporting burdens on covered bond issuers. Replacing the rating agencies' templates with a single template should help reduce reporting burdens, and thus complexities and costs of issuance.

13 For example, the Bank of England has required loan-level data on covered bonds since late 2010.

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

The ECB welcomes the recently-published ECBC Harmonised Transparency Template (HTT) as an important step forward. However, the ECB notes that it could be further improved. More specifically, the ECB notes the following.

- Market-led transparency initiatives should capture important features of the cover pool[14], as well as of the programme arrangements.
- Market-led transparency initiatives should provide transparent and clear rules on the minimum data quality standards required for the completed template.
- Market-led transparency initiatives should provide for effective governance arrangements and data quality checking procedures to ensure consistent treatment across all covered bond issuers. More centralised access to, or storage of, collected data could be valuable for this purpose.

The ECB would more generally welcome a joint effort by stakeholders (market participants, regulators, central banks, etc.) towards making already available information accessible in a more standardised format from a common point of access.

Would these templates be granular enough to enable investors to carry out a comprehensive risk analysis as recommended by the EBA?

In the ECB's view, the existing stratified "one size fits all" templates are helpful but insufficient to carry out a comprehensive in-house risk analysis, as recommended by the EBA.

The ECB would in particular like to highlight two deficiencies of stratified tables.

- It is impossible to check the overlap of risks across the cover pool with "one size fits all" stratified information.
- It is impossible and inefficient to design ex ante stratified tables that capture all possible investigations that analysts may wish to conduct across different covered bond programmes. Only more granular information empowers the user to choose which way to stratify the data, based on his/her preferences.

Would these templates be sufficient without further legislative backing to deliver enhanced and consistent disclosure in European covered bond markets?

Further legislative backing is required to ensure that there is provision of disclosure:

- in a harmonised framework using common definitions;
- with adequate granularity;
- with sufficient coverage of additional important fields (e.g. debt-to-income information);
- in a centralised manner.

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[14] Some examples of missing cover pool-related items are: (1) debt-to-income/loan-to-income distribution; (2) disclosure about loans covered by guarantee (e.g. national mortgage guarantee schemes); (3) loan origination channels; (4) purpose of the loan (purchase, construction, equity release, etc.); (5) foreign nationals in the pool; (6) information about forbearance actions on the pool (e.g. payment holidays).

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

These disclosure requirements should apply to all European covered bonds.

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

These disclosure requirements should apply to both pre- and post-insolvency/resolution of the issuer.

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

The same disclosure requirements should also apply to covered bonds issued in third countries.

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