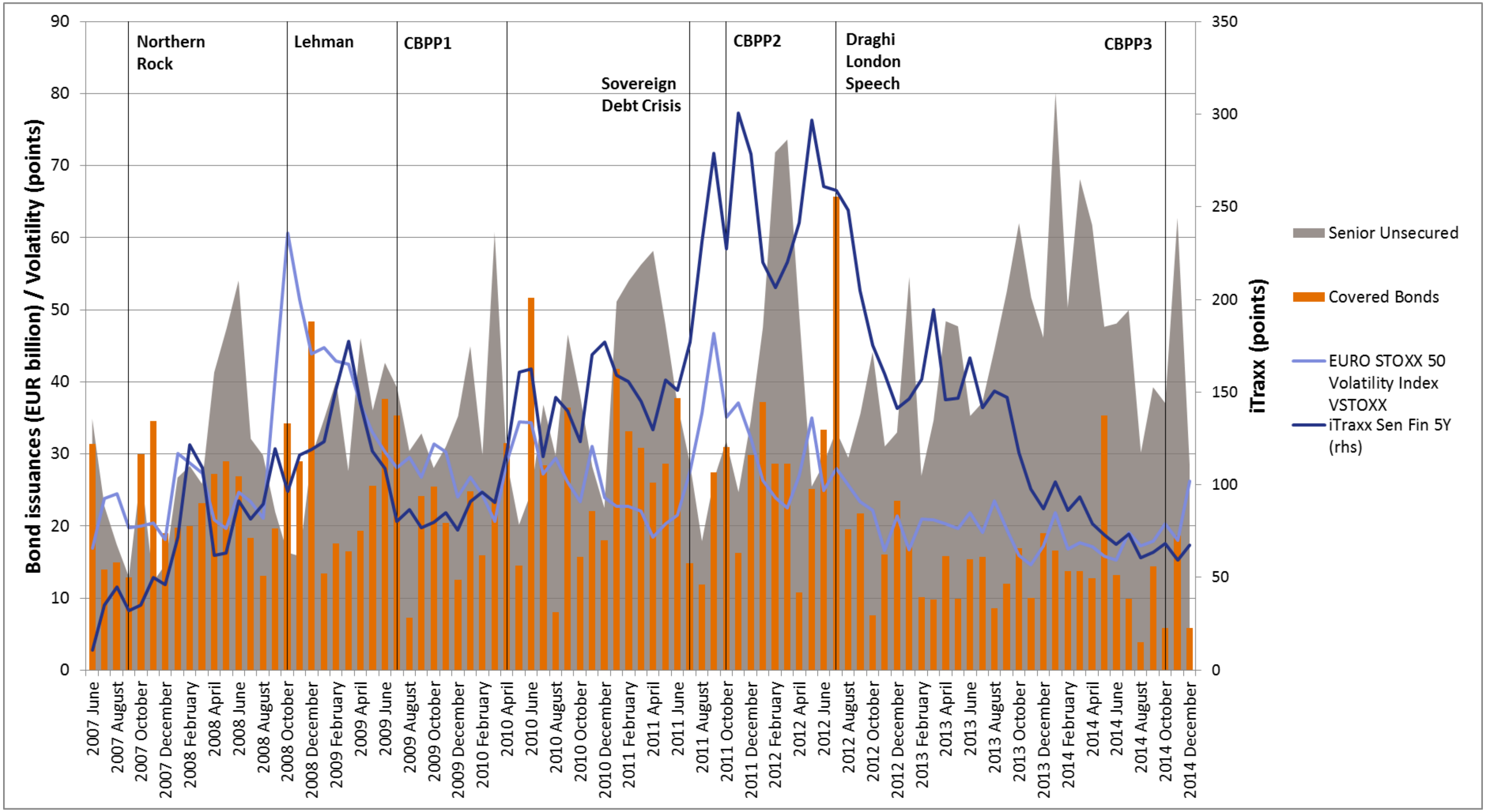
EUROPEAN MORTGAGE FEDERATION
EUROPEAN COVERED BOND COUNCIL

May 2015

ECBC European Covered Bond Council

EUROPEAN MORTGAGE FEDERATION

COVERED BONDS AS A CRISIS MANAGEMENT TOOL



Source: Bloomberg, EMF-ECBC.

Note: “Senior Unsecured” refers to all senior unsecured bonds (all face values) issued by “financials” in the EU in the given month. “Covered Bonds” refer to all covered bonds issued in the EU in the given month.

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CB, a firmly rooted product to rebuild confidence

- **1769:** Creation of Pfandbriefe in Prussia by Frederick The Great

- **1797:** “Realkreditobligationer” Danish Covered Bonds were created after the Great Fire of Copenhagen, when a quarter of the city burnt to the ground

- **1852:** Creation of “Obligations Foncières” French covered bonds

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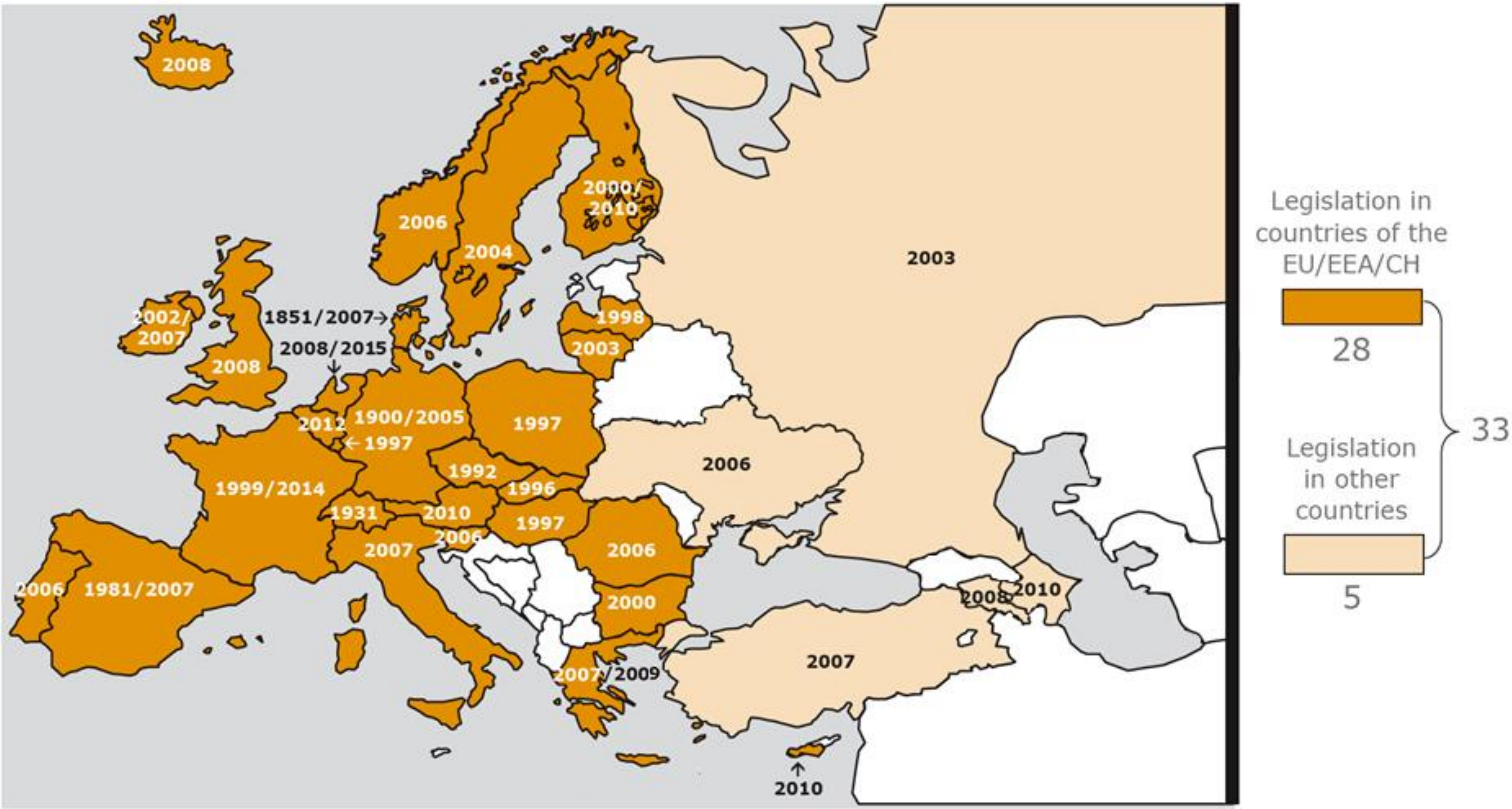
CB legislation in Europe



CB legislation

1995 Germany Jumbo Pfandbrief

1996 Slovakia CB

1997 Luxembourg LdG, Hungary CB Poland CB

1998 Latvia CB

1999 France OH & OF

2000 Bulgaria

2002 Ireland ACS

2003 Lithuania CB, UK contract CB

2004 Sweden CB

2005 Finland CB, Germany Pfandbrief Act

2006 Portugal CB, Norway CB, Romania CB Slovenia CB

2007 Canada Contractual CB, Denmark SDOs, Greece CB Italian OBG, Amended Ireland ACS, Spain CB, Turkey MCB

2008 Iceland CB, Netherlands CB, UK Regulated CB

2009 Amended Greece CB, Switzerland CB Germany Aircraft CB

2010 Austria CB Amended, Finland CB

2011 Australia CB, Cyprus CB

2012 Belgium CB, Canada CB, Chile CB, Amended Czech Republic, Panama CB

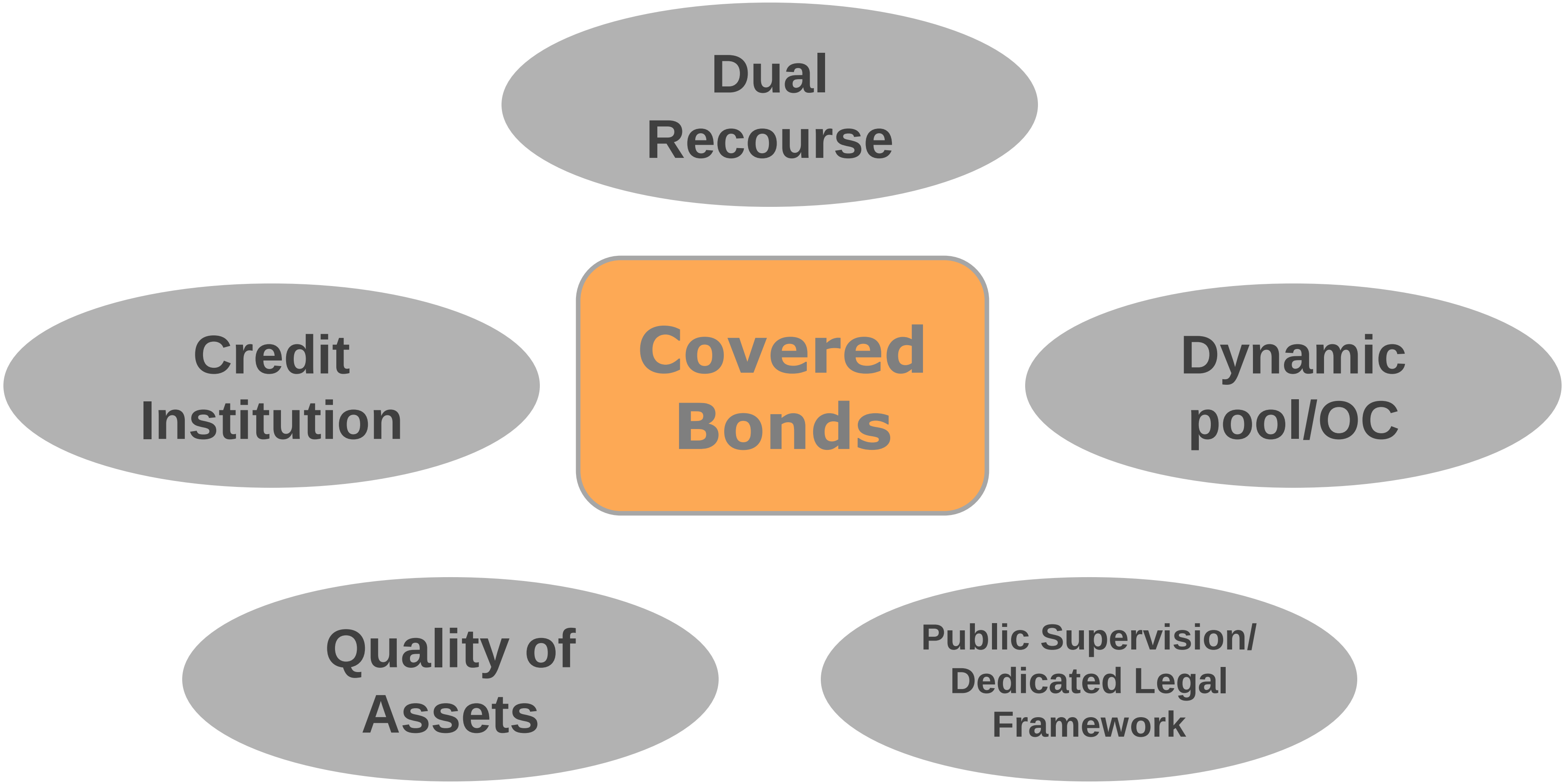
2013 South Korean CB Singapore CB New Zealand CB Amended Lux CB Amended UK Regulated CB

2014 Amdended France SCF & SFH, Amended Germany PA Amended Turkey MCB

2015 Updated Dutch CB, Expected Changes in Polish and Romanian CB

- **2013: 10 new issuers for a total of 306 issuers & 414 programmes**
- **Active covered bond markets in 30 different jurisdictions**
- **Forthcoming revision of existing legislation:**
  - In Europe: Romania, Poland
  - Outside Europe: Chile, India, Japan, Mexico, Morocco & U.S.

Essential features of covered bonds



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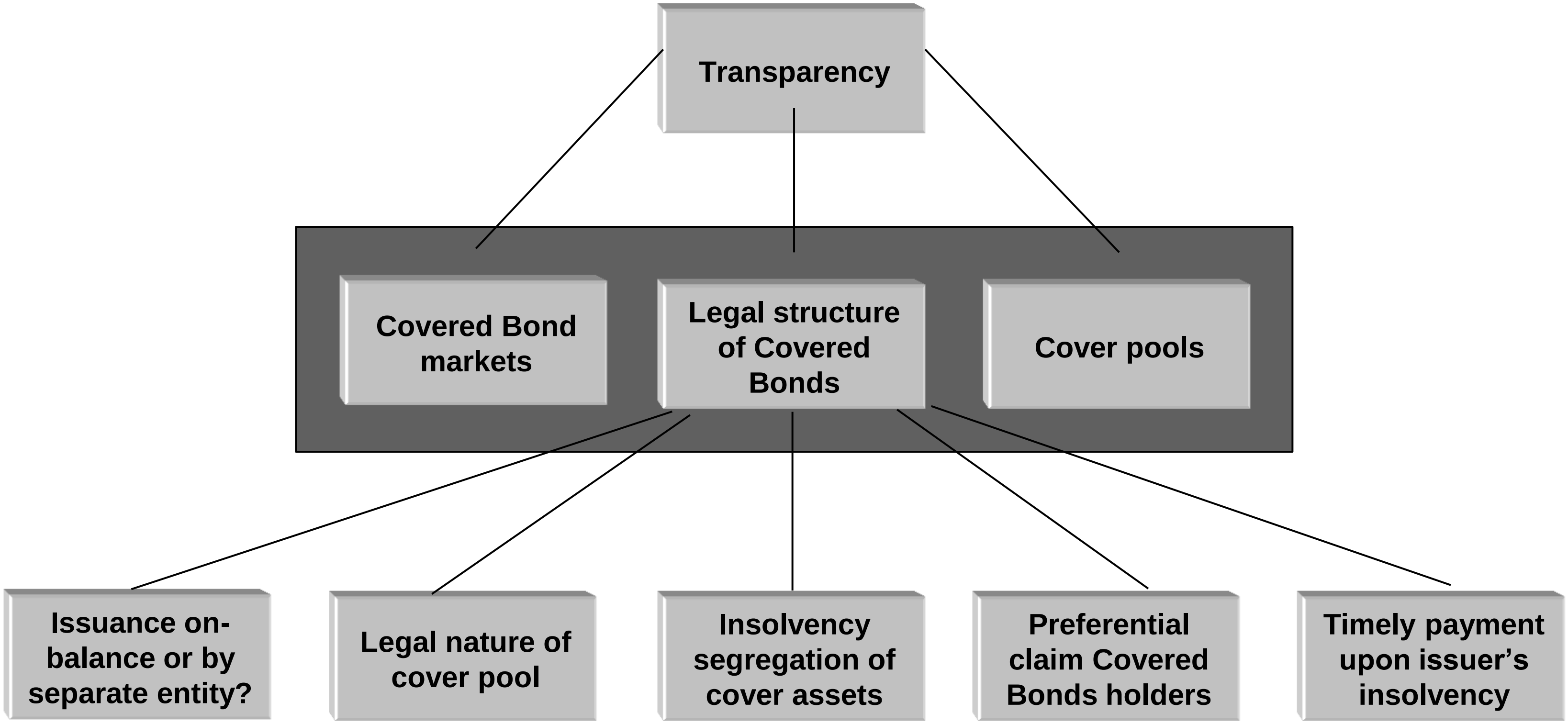
Covered Bond Framework: Main characteristics

General features of specific Covered bond laws



Covered bond, legislative cornerstones in EU

- **Art 52 (4) UCITS:**

  - CB must be issued by an EU credit institution
  - The credit institution must be subject to special public supervision by virtue of legal provisions protecting bondholders
  - Bondholders' claims on the issuer must be fully secured by eligible asset until maturity
  - Bondholders must have a preferential claim on the cover assets in case of the issuer's default

- **CRR I / CRD IV**

  - The new Capital Requirement Directive and Regulation package (CRD IV and CRR) are based on a proposal from the Basel Committee on Banking Supervision to revise the supervisory regulations governing the capital adequacy of internationally active banks.
  - The package, which entered into force on 28 June 2013 (CRR) and 17 July 2013 (CRD IV) and replaced the Directives 2010/76/EU, 2006/48/EC and 2006/49/EC.

Covered Bond Frameworks

- **Special law based (or legislative) covered bonds**, where specific legislation has been established outlining the high level requirements of the instrument and providing comfort to investors of the asset segregation in the event of bankruptcy

- **General law based (or structured) covered bonds,** where a program has been structured under general law using securitisation techniques but providing investors with the same characteristics as legislative covered bonds

- Legislative covered bonds enjoy in Europe a preferential status over structured covered bonds in two areas
  - The risk weighting is lower than for structured covered bonds
  - UCITS compliancy means a larger single name limit applies for investors

- From a structural point of view several variations have been developed over time
  - **Direct/on-balance issuance:** the originator issues the covered bonds and the assets are ring-fenced on the balance sheet of the originator
  - **Specialist issuer:** an originator establishes a credit institution subsidiary which issues the covered bonds and holds the collateral
  - **Direct issuance with guarantee (UK model):** the originator issues the covered bonds, which are guaranteed by a special purpose subsidiary of the originator, which holds the cover pool assets

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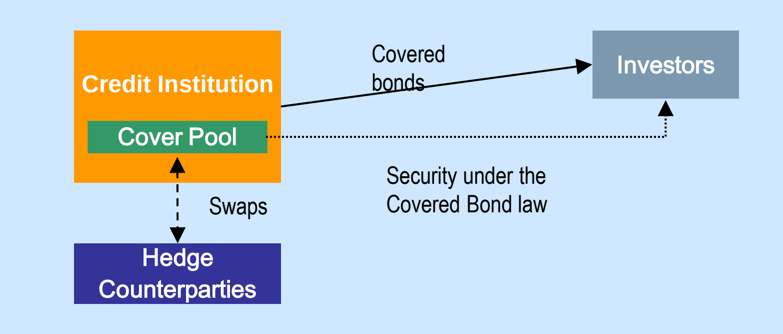
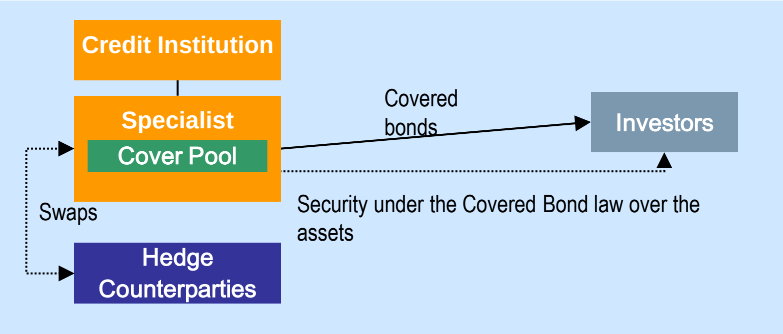
Covered Bond Program Architecture

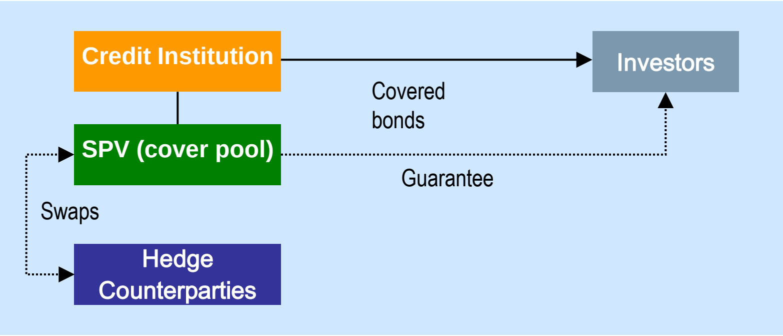
- **A direct/on-balance issue structure** is applied in in for example Germany and Spain, and has several advantages over the other structures
  - ➢ Simpler and less structured
    - o No sale required
    - o No accounting or tax implications
  - ➢ UCITS compliant (if issued under CB-law, subject to recognition by other regulators)
  - ➢ Sometimes changes in existing laws required



- The **Specialist Issuer structure** requires a special purpose credit institution to be established within the group that issues the covered bonds, which is applied in for example France, Luxembourg and Ireland
  - ➢ Specialist issuer cannot be part of the credit institution's insolvency estate
  - ➢ Cumbersome for issuers
    - o Regulated credit institution needs to be established subject to supervision of the Authorities
    - o No automatic direct double recourse to originator of loans



- **The direct issuance with guarantee structure** has been developed to avoid the need for specific legislation and uses securitisation techniques. This is applied in for example the UK, Canada and The Netherlands
  - ➢ Relatively straightforward because no specific legislation is required and similarities with securitisation
  - ➢ Regulatory approval obviously required
  - ➢ Flexible structure which allows off-shore issuance



Covered bonds from a macroeconomic perspective

- **Covered bonds' role and importance in funding strategies;**
- **Covered bonds' contribution to financial stability;**
- **Macro-prudential features => reduction of systemic risk;**
- **Housing finance from private sector.**

"Given that the financial crisis clearly exposed the dire consequences of the imprudent evaluation of credit risk, the usefulness of more conservative asset classes such as covered bonds, which have proved to be safe assets over a long time, is obvious."

Jean-Claude Trichet, European Central Bank President, July 2009.

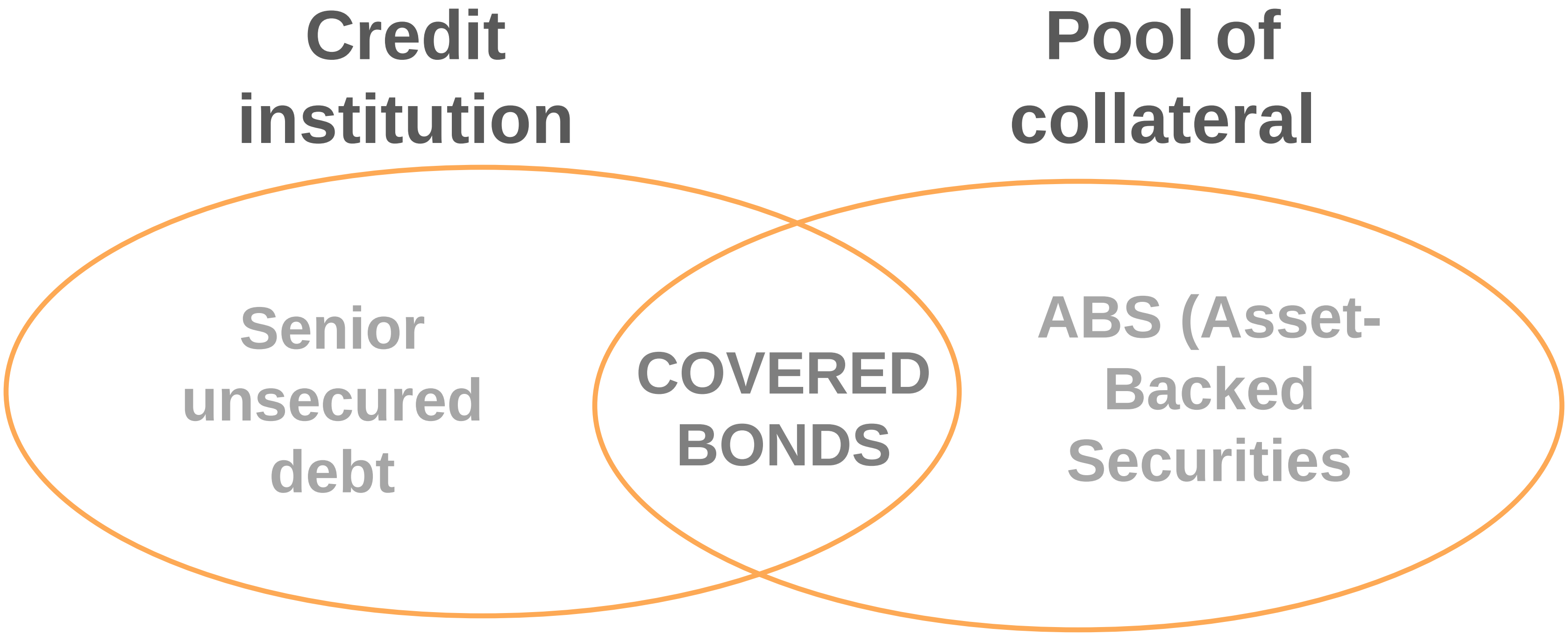
Issuers' perspective: why CBs?

- **Adding duration to liabilities, allowing banks to properly match their long-term asset portfolios;**
- **Providing stability to the funding mix, allowing ALM teams to increase predictability in their maturity profiles;**
- **Enabling issuers to increase diversification in the investor base, both in terms of geography and investor type; and**
- **Serving the industry as one of the most reliable funding tools, even in times of turmoil.**

Investors' perspective : why CBs?

- Double recourse to issuer and cover pool;
- Higher rating than unsecured debt;
- Lower risk weighting for EEA CB bought by EEA banks;
- Favourable treatment under Solvency II;
- Generally better level of liquidity through larger issue size;
- Favourable REPO treatment at ECB and other Central Banks;
- Basel III eligible as liquid asset as Level II 40% cap & 15% hc
- No risk of bailing in.

Covered bond: a dual-recourse instrument



EMF
ECBC

European Mortgage Federation
European Covered Bond Council

Rue de la Science 14, 2nd Floor - B-1040 Brussels - Belgium

www.hypo.org   emfinfo@hypo.org   ecbcinfo@hypo.org

@EMF_ECBC   EMF-ECBC

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