



Treatment of Covered Bonds under the new EU Capital Requirements Directive

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Overview

- CRD voted by EP on 28 September 2005
- ECOFIN Council reached 'political agreement' on 11 October, the formal vote being scheduled for November or December ECOFIN
- Covered Bond Treatment
 - The CRD general approach to covered bonds
 - Eligible assets: Annex VI, part 1, paragraph 65 a) to e)
 - Modified Standardised Approach:
 - Foundation IRB Approach: Annex VII, part 2, paragraph 8 d)
 - Advanced IRB Approach ?
 - Outstanding issues



The CRD general approach to covered bonds

- Covered bonds are considered as secured loans to the issuing institution, i.e. the general approach for secured lending also applies to covered bonds. The Directive proposal does not recognise a specific methodology for the treatment of covered bonds
- CRD Annex VI, Part 1, Par. 68: „Covered bonds shall be assigned a risk weight on the basis of the risk weight attributed to senior unsecured exposures to the credit institution which issues them“.
- The consequence is
 - under MSA: the weighting of covered bonds is derived from the weighting of the issuing institution
 - under IRBA: the probability of default (PD) of the covered bond is determined by the PD of the issuing institution



ECBC position with respect to the CRD approach

- The Directive's approach ignores the characteristics of European covered bond legislations as defined by Art. 22 IV UCITS Directive, in particular the existence of a preferential claim of bondholders on assets which would be used on a priority basis for the reimbursement of the principal and the payment of interests in the event of failure of the issuer
- Cover assets shall economically be considered as the primary debtor of the bondholder, the issuing institution being only the secondary debtor of the covered bond investor
- The weighting approach to covered bonds shall be focused on the issue itself and not on the issuing institution



Eligible Assets

- CRD will probably allow for 5 types of asset classes:
 - Exposures to public sector entities (par. 65 (a), (b))
 - Exposures to institutions (par. 65 (c))
 - Mortgage loans (residential & commercial) (par. 65 (d), (e))
 - Senior MBS issued by securitisation entities (par. 65 (d), (e))
 - Loans secured by ships (par. 65 (ea))



Exposures to public sector entities

- Exposures to or guaranteed by central governments, central banks, public sector entities, regional gov'ts and local authorities in the EU (no credit quality assessment)
- exposures to or guaranteed by non-EU central gov'ts, non-EU central banks, multilateral development banks, international organisations, non-EU public sector entities, non-EU regional gov'ts and non-EU local authorities
 - that qualify for credit assessment step 1 (AAA to AA-)
 - i.e. 0% risk weight for central gov'ts and 20% risk weight for regional and local authorities)
 - that qualify for credit assessment step 2 (A+ to A-)
provided that they do not exceed 20% of the nominal amount of outstanding covered bonds of issuing institutions
 - i.e. 20% risk weight for central gov'ts and 50% risk weight for regional and local authorities



Exposures to institutions

- Eligible exposures to credit institutions are qualified as 'regular cover' (in opposite to the qualification as 'substitution assets' by some national covered bond legislations)
- Institutions have to qualify for the credit quality assessment step 1 (= 20% weighting)
- Exposures to credit quality assessment step 2 institutions (50% weighting) are eligible if they do not exceed 100 days
- Total exposure shall not exceed 15% of the nominal amount of outstanding covered bonds of the issuing credit institution
- Exposures caused by transmission and management of payments or liquidation proceeds are not comprised by the 15% limit



Mortgage loans

- Loans secured by residential real estate collateralised by prior liens up to 80% of the value of the pledged property
- Loans secured by commercial real estate collateralised by prior liens
 - up to 60% of the value of the pledged property
 - up to 70% of the value of the pledged property, if the value of the cover assets exceed the outstanding amount of covered bonds by at least 10%



Senior MBS issued by securitisation entities

- Senior units issued by French Fonds Communs de Créances or by equivalent EU securitisation entities securitising residential / commercial real estate exposures, provided that
 - at least 90% of the assets of such securitisation entities are composed with first rank mortgages up to 80% (residential) / 60% (commercial) of the value of the pledged property
 - the units qualify for the credit quality assessment step 1 (AAA to AA-)
 - the units shall not exceed 20% of the nominal amount of the outstanding issue
 - until 31 December 2010, the 20% limit does not apply provided that the RMBS / CMBS units are AAA-rated. This period may – if appropriate – be extended with / without a further review clause



Weighting of Covered Bonds under MSA (Annex VI, part 1, paragraph 68)

Covered bonds shall be assigned a risk weight on the basis of the risk weight attributed to senior unsecured exposures to the credit institution which issues them:

Unsecured exposure to the institution: risk weight	Covered bond risk weight
20%	10%
50%	20%
100%	50%
150%	100%

N.B: A general 10% risk weight of covered bonds seems only available if the competent authority applies 'option 1' to the risk weight of institutions (one notch below the risk weight of the respective central government)



Weighting of Covered Bonds under Foundation IRBA

- Probability of default (PD)
 - as the general risk weight function for institutions applies, the Foundation IRBA approach for covered bonds is based on the PD of the issuing institution
 - The PD of an exposure to an institution shall be at least 0,03% (Annex VII, Part 2, par. 2). It has to be estimated internally by each IRB bank
- Supervisory loss given default rate (LGD): Annex VII, Part 2, par. 8 (d)
 - CRD will apply a 12,5% LGD rate to covered bonds
 - Under certain strict requirements, a 11,25% LGD may be assigned to covered bonds.



Requirements for a 11,25% LGD

- No step 2 assets regarding
 - EU public sector loans (central governments, regional, local authorities, public sector entities)
 - Non-EU public sector loans
 - Institutions
- Eligible RMBS and CMBS restricted to 10% of the nominal amount of the outstanding issue
- No ship mortgages as cover assets

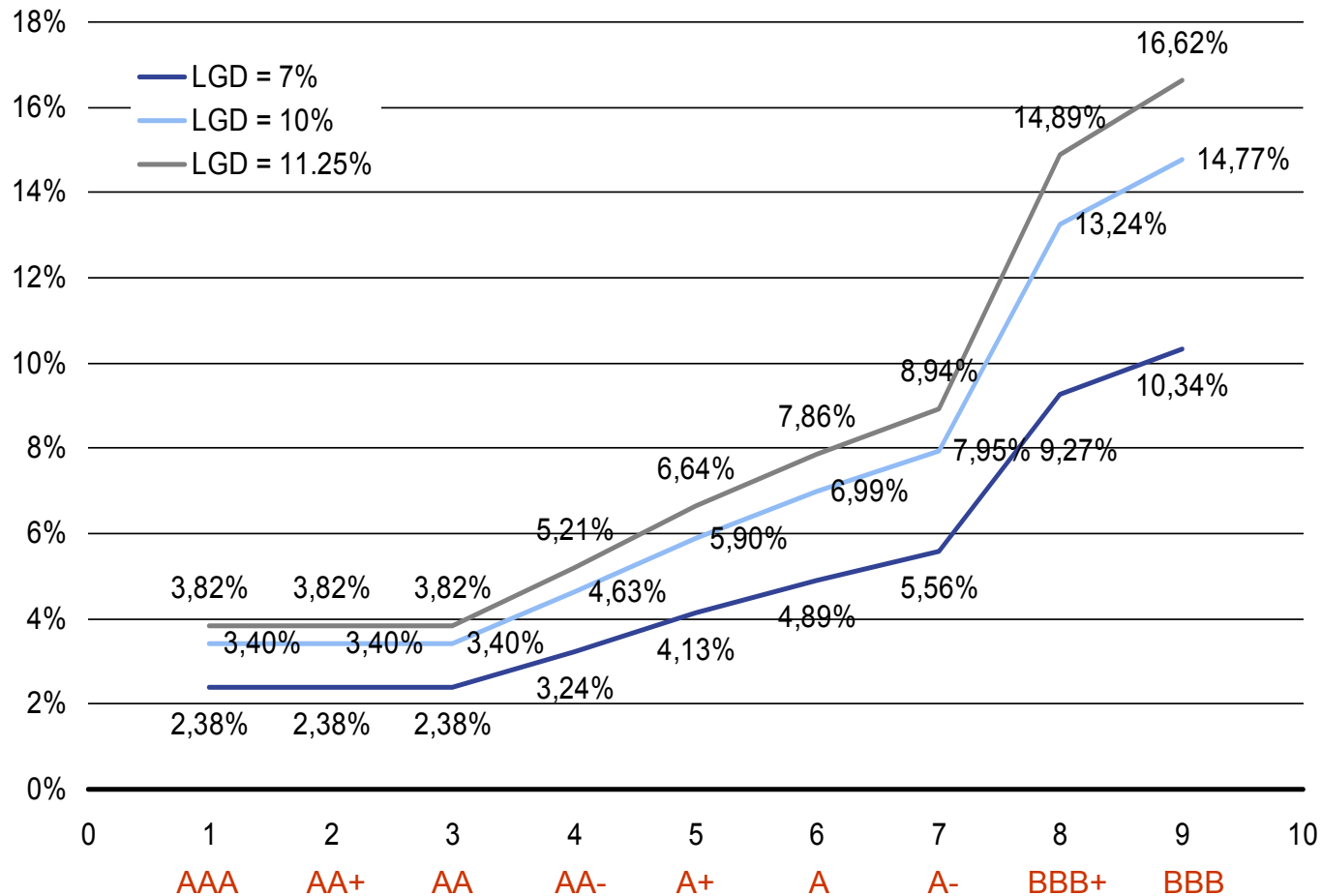
OR (!)

- covered bonds are AAA rated

The 11,25% derogation shall be reviewed on 31 December 2010, the COM being asked to make new proposals



Covered bonds risk weight curve under Foundation IRBA



Source: HVB Global
Market Research



Weighting of Covered Bonds under Advanced IRBA

- LGD ratios of covered bonds have to be measured by the advanced IRB bank itself
- The IRBA methodology does not allow the institution to use 'third party data'; the calculation of LGD's has to rely on own estimates of the IRB bank
- EP amendment to allow the use of data provided by the issuing institution has been rejected
- The supervisory LGD ratios (12,5% / 11,25%) shall be applicable by advanced IRB banks as well
- Is there an advanced IRBA for Covered Bond weightings available ?
 - IRB approaches allow for the use of 'external information'
 - To which extent could an internal LGD estimate model be built on 'external information' ?



First outstanding issue: Covered bond = secured loan to the issuing institution ?

- The weighting of covered bonds should be based on the quality of the cover assets (instead of the quality of the issuing bank)
 - MSA: the weighting should be based on the rating of the issue instead of the rating of the issuing institution
 - IRBA: the weighting should not be based on the PD of the issuing institution, but on the PD of the cover assets
- The focus on the cover assets raises the following concerns:
 - The covered bond default depends upon the failure of two counter parties (the bank and the underlying borrowers), but a double default approach for covered bonds was expressly excluded
 - The PD of the issue being based on the aggregated PD's of the underlying borrowers would need a granularity factor providing a leverage effect
 - Impact of such a structured approach on the remaining bank's assets



Second outstanding issue: The treatment of covered bonds under the advanced IRBA

- LGD evidence of cover assets show that the ‘true’ LGD ratio of covered bonds is situated well below 10%
- An own LGD estimate by the advanced IRB bank would probably result in significantly lower LGD’s and consequently lower covered bond weightings compared to the weightings achieved by the application of the supervisory 12,5 / 11,25% LGD ratio
- How can an internal LGD estimate model for covered bonds be built up from ‘external information’ ?
- How to deal with the maturity charge for durations up to 5 years and beyond ?



Third outstanding issue: Improvement of the 11,25% LGD beyond 2010

- There is evidence from former EU-15 that average LGD ratios of mortgage cover assets are being situated between 6% and 8%
- There is evidence that European LGD ratios of public sector lending are close to 1%
- LGD evidence has to be extended to EU-25 in order to improve consistency and representativity of figures