ECBC ESSENTIAL FEATURES OF COVERED BONDS

The ECBC sets out below what it considers to be the essential features of covered bonds, together with explanatory notes. It is intended that they to be read independently from any other definition or interpretation of covered bonds, such as those set out in the undertakings for collective investment in transferable securities (UCITS) and paragraph 68, Annex VI of the Banking Consolidation Directive (BCD).[1] These common essential features should be understood as the ECBC's minimum standards for covered bonds.

Essential Features

Covered bonds are characterised by the following common essential features that are achieved under special-law based frameworks or general-law based frameworks:

1. The bond is issued by—or bondholders otherwise have full recourse to—a credit institution which is subject to public supervision and regulation;

2. Bondholders have a claim against a cover pool of financial assets in priority to the unsecured creditors of the credit institution;

3. The credit institution has the ongoing obligation to maintain sufficient assets in the cover pool to satisfy the claims of covered bondholders at all times;

4. The obligations of the credit institution in respect of the cover pool are supervised by public or other independent bodies.

Explanatory Notes

Covered bonds are characterised by the following common essential features that are achieved under special-law based frameworks or general-law based frameworks

Special-law based frameworks

A special-law based framework is a legal framework based on a law and/or binding regulations of a public supervisory authority, specifically dedicated to regulate a covered bond system of a country. As of December 2007, special-law based frameworks exist in 26 countries in Europe.

Bonds issued in accordance with a special covered bond law may benefit from preferential risk weightings in the hands of certain regulated investors, depending on the jurisdiction of the investor and whether the bond otherwise meets the requirements of Article 22(4) of UCITS and paragraph 68, Annex VI of the BCD.

General-law based frameworks

1 Also known as the Capital Requirements Directive (CRD). See 2006/49/EC and 2006/48/EC.

A general-law based framework is a legal framework based on general law (such as contract law) or on law and/or regulations of a country not specifically dedicated to regulate a covered bonds system. As of December 2007, covered bonds based on general law-based frameworks exist in five countries worldwide.

1. The bond is issued by—or bondholders otherwise have full recourse to—a credit institution which is subject to public supervision and regulation;

Full recourse

A full recourse right creates an unrestricted unconditional obligation on the credit institution to repay a debt. Generally, default on a full recourse obligation leads to the insolvency of the obligor, and the creditor will have a claim on the general insolvency estate of the obligor on an equal basis with the other general creditors of the obligor.

In most covered bond structures, the bond is issued by a credit institution, giving investors direct full recourse to the credit institution's full resources. In some structures, however, the covered bond is issued by a special purpose entity (SPE), which on-lends the proceeds to a credit institution (whether by making a loan or buying a bond). This provides bondholders with full recourse to the underlying credit institution, albeit indirectly, through the SPE. For investors subject to the BCD, only covered bonds issued directly by a credit institution qualify for preferential risk weightings.

Full recourse to a credit institution is a key difference between securitisation and covered bonds. In securitisations, bondholders' only recourse is to the cashflows from a securitised portfolio of assets. The credit institution which originated the assets typically does not guarantee the performance of the securitisation. Therefore, if the cashflows from the securitized portfolio are insufficient to make payments on the securitisation units when expected, holders of the units would generally have no claim against the credit institution which originated the securitised assets.

A credit institution which is subject to public supervision and regulation

A credit institution is an entity licensed to carry on one or more banking activities, such as receiving deposits from the public, granting loans or providing payment services. Credit institutions are distinct from corporates in that—owing to their importance to the financial system—they are subject to public supervision and regulation which prescribes standards for the management of credit, liquidity, interest rate and operational risks.

2. Bondholders have a claim against a cover pool of financial assets in priority to the unsecured creditors of the credit institution;

Financial assets

Financial assets include loans, bonds and similar instruments, as well as derivatives designed to hedge interest and currency risks. Financial assets do not include equity securities, real property, commodities or tangible property. The most common cover assets are mortgage loans secured on residential or commercial property (or securitisation units backed by residential or commercial mortgage loans), mortgage loans secured on ships and loans to public sector entities. Most cover pools also include cash deposits and loans against credit institutions.

All covered bonds contain minimum cover pool asset quality standards. For covered bonds issued under a special law, these quality standards are set out in the law itself and/or binding regulations;

however these may also be supplemented by contract. Where the covered bond is issued under general law, these quality standards are set out in the contracts which govern the covered bond issuance.

The BCD also imposes certain minimum standards for cover pool assets. For investors subject to the BCD, only covered bonds with BCD-compliant and national legislation compliant cover pools are eligible for preferential risk weightings.

Cover pool; priority to unsecured creditors

A cover pool is a clearly identified, "ring-fenced" pool of assets dedicated to secure the covered bonds. That is to say, in the event of the insolvency of the credit institution, the assets in the cover pool will be used to repay the covered bondholders before they are made available for the benefit of the credit institution's unsecured creditors.

The method used to "ring-fence" the cover pool varies. In most jurisdictions, the special law either excludes the cover pool from the insolvency estate of the credit institution, or provides covered bondholders with a preferred claim within the insolvency estate itself. In some jurisdictions, the cover pool is preserved from the insolvency estate of the credit institution by being transferred to an SPE, which guarantees the credit institution's obligations under the covered bond. Finally, some structures use the implementation of European Collateral Directive in their jurisdiction to pledge the cover pool assets.

3. The credit institution has the ongoing obligation to maintain sufficient assets in the cover pool to satisfy the claims of covered bondholders at all times;

Sufficient assets

The value of the cover pool assets meeting the minimum quality criteria described above must be at least equal to the value of the covered bonds.

In most jurisdictions, the value of the cover pool is required to exceed the value of the covered bonds by a prescribed amount, known as overcollateralisation. The minimum level of overcollateralisation is set by the special law or within the contracts governing the covered bond issuance. In some cases, the minimum level of overcollateralisation may be set by a combination of the two—the covered bond law prescribing a minimum level of overcollateralisation, but the credit institution committing to a higher level through either voluntary, non-binding commitments or contract.

Ongoing obligation

The credit institution has the obligation to ensure that the value of cover pool assets meeting the minimum quality criteria described above is equal to or higher than the value of the covered bonds at all times. The credit institution may therefore be required to add further assets to the cover pool to compensate for matured or defaulted assets. . In addition, the credit institution may be required to comply with specific provisions for mitigating different kinds of risks related to the management of cover pool and covered bonds, such as interest rate risk, FX risk or maturity mismatch.

In securitisations, by contrast, the sponsoring credit institution is generally not compelled to replace assets which enter into default after they have been transferred into the securitisation portfolio. Therefore, if defaults in the securitised portfolio are higher than anticipated when the securitisation was issued, the resulting losses will be borne by the investors in the securitisation, rather than by the sponsoring credit institution.

4. The obligations of the credit institution in respect of the cover pool are supervised by public or other independent bodies.

Supervision of the credit institution's obligations in respect of the cover pool ("special" supervision) is supervision specifically for the benefit of covered bondholders, as opposed to supervision relating to the general stability of financial or other markets, general customer interest, deposit protection, and the like.
Special supervision is therefore distinct from the general supervision of the credit institution referred to in paragraph 1 above. Each form of supervision is an "essential feature" common to Covered Bonds, as listed above.

The content and the level of the "special" supervision in respect of the cover pool varies from one system to another.

Typical features of "special" supervision include:

- a special cover pool monitor
- periodic audits of the cover pool by the cover pool monitor
- ongoing management and maintenance of the cover pool upon the credit institution's insolvency to ensure the timely payment of covered bondholders.

In special-law based frameworks, the task of special supervision is usually assigned to public authorities and the issuer is required to obtain a licence to issue covered bonds. In many countries, this public authority is the banking supervision authority; in others, the capital market supervision authority; in some, both. These public authorities will also appoint or approve the cover pool monitor, and these authorities may also conduct their own audits of the cover pool from time to time.

Special public supervision is a condition of Art. 22 (4) of the UCITS directive and of several other EC directives (including those regarding insurance companies and deposit insurance), making bonds which are subject to special public supervision eligible for favourable investment limits for certain investors. In addition, for investors subject to the BCD, only covered bonds subject to special public supervision are eligible for preferential risk weightings.

In covered bonds issued under general law frameworks, the key features of special supervision are replicated by contract, to the extent possible. Therefore, for example, the issuing or sponsoring credit institution will appoint an external auditor to audit the cover pool, and an external trustee will be appointed to safeguard bondholders' interests: changes to the contractual documents which set the terms of the programme may not be changed without the consent of the trustee, for example.

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