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PUBLIC HEARING ON THE POTENTIAL IMPROVEMENT OF THE REGULATORY FRAMEWORK OF COVERED BONDS

Article 503 of Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 foresees the revision of the regulatory framework on covered bonds. Section 1 of said article requires the European Commission, by 31 December 2014, after consulting EBA, to report to the European Parliament and to the Council, on whether the risk weights laid down in Article 129 are adequate for covered bonds. Last July 1st, EBA highlighted in its ***Opinion on the preferential capital treatment of covered bonds***, the importance for covered bonds to meet certain criteria, in particular, the existence of minimum levels of overcollateralization (OC) and liquidity buffers, the ex-ante supervision of the covered bonds issuance program and the need to further develop and clarify the information requirements foreseen in article 129.7 CRR.

Given the aforementioned international analysis, which will probably link risk weights to the fulfilling of certain criteria, it is advisable to revise the Spanish legal framework for covered bonds to see what improvements could potentially be introduced therein.

These are the **main areas** that have been identified at a preliminary stage:

- Possible **reduction of the levels of asset encumbrance** of issuing institutions, especially regarding *«cédulas hipotecarias»*.
- **Clarification of the rights of the covered bondholders in case of insolvency** of the issuing institution by segregating the cover pool.
- **Indexation of the value of the cover pool assets** and, when needed, of their collateral.
- **Redefinition of the eligible assets for each type of covered bonds.**
- Additional **liquidity management** measures.
- Publication of **more complete, transparent and homogeneous information** by issuing institutions.
- Creation of the figure of the **asset pool monitor** to supervise the fulfilling by the issuer of their obligations.

Given the potential impact of a reform of the legal framework of covered bonds, competent public authorities (the Spanish Treasury, the Bank of Spain and the Spanish Securities and Exchange Commission) deem it appropriate to conduct a public hearing as a means of gathering the opinion of any potential stakeholder. The contributions do not need to refer only to the questions raised in this document, but could relate to any aspect of the covered bond regulation.

To this end, any contribution should be sent before November 24 to the following e-mail address: audiencia@tesoro.mineco.es.

1. POSSIBLE REDUCTION OF THE LEVELS OF ASSET ENCUMBRANCE.

The issuance of covered bonds leads to asset encumbrance, irrespective of the nationality of the issuing institution, the applicable law and the country of issuance. This fact could have negative effects on the issuers by making non secured issuances more expensive and reducing liquidity in case of potential market disruptions.

It is therefore worthwhile thinking about the adoption of measures that would help reduce the level of asset encumbrance.

Question 1: Do you deem it necessary to adopt measures to reduce the level of asset encumbrance stemming from the issuance of covered bonds?

In the case of Spanish *«cédulas hipotecarias»*, every mortgage loan, irrespective of its compliance with the rules to be considered an eligible collateral asset, is automatically affected to the cover pool. Besides, minimum mandatory OC levels in Spain are higher than in the vast majority of other EU Member States. Both factors lead to a significant increase of the asset encumbrance levels for Spanish credit institutions.

In order to cater for the reduction of the asset encumbrance levels created by the issuance of *«cédulas hipotecarias»*, several legal modifications could be envisaged. In the specific case of *«cédulas hipotecarias»*, the elimination of non-eligible collateral assets from the cover pool could be considered.

Question 2: Do you deem it appropriate to adopt measures to address the potential effects of an excessive OC level? In particular, do you believe it would be advisable to eliminate non eligible collateral assets from the cover pool?

Even if non-eligible collateral assets were eliminated from the cover pool, there could still be an excessive OC level. As a means of tackling this issue, the minimum level of OC could be replaced by a single mandatory OC level.

Question 3: Do you believe it is necessary to eliminate from the cover pool part of the eligible assets if the OC level is above the mandatory level? Should that be the case, do you deem it appropriate to replace the minimum level of OC by a single mandatory OC level (could vary depending on the type of covered bond)? Where would you place the single mandatory OC level?

If part of the eligible assets were excluded from the cover pool, two new asset categories would arise: (1) selected assets and (2) eligible but non-selected assets. This fact would make it advisable for issuing institutions to count on some type of mechanism to allow them to choose the highest quality assets amongst the eligible ones. The selection of those assets could be done through some kind of automatic or semiautomatic algorithm.

Question 4: Do you deem it appropriate to establish two new asset categories (selected assets and eligible but non selected assets)? If so, how do you believe that regime should work and which variables should be more relevant (credit quality, time to maturity etc.)? Do you think it would be necessary to create a transition period to progressively exclude these assets from the cover pool?

2. SEGREGATION OF THE COVER POOL PORTFOLIO.

In other European jurisdictions, the cover pool assets, together with substitution assets and cover derivatives, are transferred to a separate financial vehicle. This operation allows for the cover pool portfolio to be perfectly segregated, providing covered bondholders with total legal certainty and avoiding the emergence of any judicial remedy.

In Spain, a special accounting register was created in 2007, allowing issuers to have a clear classification of the loans and credits used as collateral.

Question 5: Which mechanism would work the best as a means of ensuring a perfect segregation of the cover pool assets? In particular, do you deem it advisable to transfer the cover pool assets to a separate financial vehicle?

In the French and German jurisdictions, the separate financial vehicle is a credit institution which should, in principle, have access to the liquidity facilities of the ECB. In France, the separate credit institution is created from the very beginning, whereas in Germany, the separate credit institution is created following the declaration of the parent company in bankruptcy. Alternatively, other financial vehicles, such as Special Purpose Vehicles (SPVs) could be used to ensure the segregation of the cover pool.

Question 6: Should you consider the creation of a separate financial vehicle is the best way to ensure the isolation of the cover pool portfolio, what legal form should it take? When should the assets be transferred to the separate vehicle? Do you believe the isolation of the assets could be done through the creation of a SPV at the start of the insolvency proceeding?

Another alternative, in line with what is foreseen with the German figure of *Sachwalter*, would be to appoint a separate insolvency administrator, who would be in charge of protecting the rights of bondholders in case the issuer went bankrupt.

Question 7: Should it be legally feasible, how would you assess the introduction of a separate insolvency administrator? What advantages and disadvantages would it have? What role would the separate insolvency administrator play in case the cover pool assets were transferred to a separate vehicle?

3. UPDATING OF THE VALUE OF THE LOANS INCLUDED IN THE COVER POOL ASSETS PORTFOLIO.

The correct valuation of the cover pool over the life of the covered bonds could help investors know exactly the risks they face at any given time. In this sense, it could be positive if the valuation transmitted to investors or even used to compute the issuance limits of the credit institution matched reality as much as possible.

Question 8: Do you deem it positive to constantly update the value of the cover pool assets? If so, what effects would you attach to that updating? Would those effects be merely informative, have an impact on the issuance limits, others?

The net accounting value of many loans is often lower than the nominal value due to the implementation of provisions against potential losses. However, many of these provisions do not reflect an impairment, but just stem from general regulatory requirements (e.g. general provisions). Therefore, it could be interesting for issuers to provide investors with the accounting value net of specific provisions, that is, the value net of provisions that correspond with a true loss of value.

Question 9: Do you think it would be advisable to compute the accounting value net of specific provisions for the cover pool assets? Do you believe there is a more appropriate updating methodology?

In the case of mortgage loans and mortgage credits, apart from the already mentioned updating methodology, it could prove useful for the issuer to update the loan to value (LTV) of the loans and credits included in the cover pool. In fact, the evolution of the real estate market as well as the amortization of the principal of the mortgage loans may significantly change the LTV. While it is easy to ascertain the numerator of the ratio of the LTV calculation, getting to know the true value of the collateral of the mortgage loan at any given moment in time may become a complex task. For this reason, it could be interesting to also update the value of the collateral of the mortgage loans included in the cover pool.

Nevertheless, before establishing any updating methodology for the collateral of the mortgage loans, it is of utter importance to estimate the transitional impact such a measure could have on outstading issuances.

Question 10: Do you deem it appropriate to update the value of the collateral of the mortgage loans included in the cover pool? Should there be a continuous updating of their value, what would be the expected impact on issuing credit institutions? What mechanisms for mitigation would you propose?

Was an updating methodology for the valuation of the collateral of the mortgage loans included in the cover pool legally established, the value of the assets given as collateral could be periodically updated following the evolution of an index for real estate prices. Said index should be granular enough to allow for relatively heterogeneous real estate assets to be classified into different categories.

Amongst the different official indexes that follow the evolution of real estate prices, there are two that could be highlighted: *«Índice de Precios de Vivienda»* produced by the Spanish

National Institute for Statistics (INE), and *«Índice General de Precios de Vivienda»* produced by the Infrastructure Ministry.

Question 11: Do you believe it would be advisable to update the value of the collateral of the mortgage loans included in the cover pool following the evolution of an index for real estate prices? Should that be the case, what index do you deem most appropriate for said updating? With what periodicity should that updating take place? Would you suggest the application of any other type of updating methodology?

If the granularity of the chosen index could not be total, the actual evolution of the price of the collateral could differ from the category it has been included in. For this reason, once the mortgage loan LTV has reached the maximum levels legally allowed, it could be interesting to require the issuers to count on the analysis of an independent expert, who would perform an individual valuation of the collateral of the mortgage loan.

Question 12: Do you believe the above proposed mechanism is a good way of mitigating the potential mismatch between the index of real estate prices and the actual evolution of the collateral of the mortgage loan? Do you think there are other methods to better mitigate that mismatch?

If the LTV of the mortgage loan included in the cover pool was finally updated, it could be interesting to determine what the legal effects of the LTV reaching the maximum legally allowed level would be. In this sense, different possibilities could be envisaged, like the elimination of that asset from the cover pool or the maintenance of the total loan assignment, but calculating the issuance limit taking only into account the amount of the loan that enables the LTV to be within the required limits.

Question 13: What consequences should the noncompliance with the legal LTV requirements trigger?

4. REVIEW OF ELIGIBLE ASSETS.

4.1. CÉDULAS HIPOTECARIAS.

4.1.1. RESIDENTIAL MORTGAGE LOANS WITH LTV ABOVE 80%.

Article 129 of CRR states that for a covered bond to enjoy preferential treatment in terms of capital relief, only the part of the home mortgage loan that does not exceed an LTV of 80% will be taken into account as a cover pool asset. In order to avoid any confusion between national law (which in some cases allows the LTV of the collateral asset to reach 95 %) and EU legislation, it might be appropriate to eliminate this specificity from the Spanish legislation.

Question 14: What effects do you expect from the above mentioned elimination?

4.1.2. REDEFINITION OF DEVELOPER LOAN.

Paragraphs 2, 3 and 4 of Article 12 of Royal Decree 716/2009 of 24 April lay down a number of conditions to prevent an excess of developer loans from entering the cover pool. For the specific case of mortgage loans and credits whose collateral consists of buildings under construction, the Spanish legislation foresees the following:

- The value of the loan used as collateral of the covered bond is determined by the sum of 50 % of the estimated value of the land and 50 % of the value of the work carried out.

- Such loans may not be more than 20 % of the value of the cover pool.

However, it might be appropriate to improve these legal provisions in order to avoid, for instance, that after the completion of the construction of a building, the above mentioned requirements cease to apply, even if the property has not been sold. This goal could be achieved, for example, by extending the aforementioned 20 % limit to all finished but unsold dwellings. Furthermore, the value of the loan used as collateral of the covered bond could be determined as the sum of 60 % (instead of 50 %) of the estimated value of land and 60 % of the value of the works carried out, provided that these loans do not represent more than 10 % (instead of 20 %) of the value of the cover pool assets.

Question 15: Do you consider it appropriate to redefine the concept of developer loan for the purpose of its eligibility as collateral asset of «cédulas hipotecarias»? Do you agree with these proposals? Would you add or eliminate any of these proposals?

4.1.3. CLARIFICATION OF THE CONCEPT OF NON PERFORMING LOAN.

Article 12.1.b) of Royal Decree 716/2009 prevents past due loans or the past due part of said loans from being included in the cover pool of *«cédulas hipotecarias»* and *«bonos hipotecarios».*

This disposition guarantees the exclusion of non-performing loans from the cover pool. In order to avoid possible divergences in the interpretation of this concept by different credit

institutions, it could be interesting to define the idea of non-performing loan in quantitative terms as loans in arrears of 90 days or more.

Furthermore, as a means of providing Spanish covered bonds with the highest quality, the concept of non-performing loan could be extended to the refinancing operations provided for in Annex IX of Circular 4/2004 of Bank of Spain, of December 22.

Question 16: Do you deem it appropriate to redefine the concept of non-performing loan in quantitative terms? Do you agree with the inclusion of refinancing operations under the concept of non-performing loans?

4.2. CÉDULAS TERRITORIALES

According to article 13 of Law 44/2002, of November 22, the following assets can be used as collateral of *«cédulas territoriales»:*

a) the loans and credits granted by the issuer to the State, the Autonomous Regions and the Local Bodies as well as to autonomous bodies and public corporate entities dependent on the former.

b) the loans and credits granted by the issuer to central governments, regional administrations, local authorities, autonomous bodies, public corporate entities and other entities of a similar nature of the European Economic Area which do not belong to the Spanish State, provided that those funding facilities are not linked to the financing of export contracts for goods and services or the internationalization of companies.

4.2.1. INCLUSION OF THE DEBT ISSUED BY PUBLIC BODIES AS COLLATERAL.

The possibility could be explored to allow «*cédulas territoriales*» to be covered by the debt issued by the public bodies article 13 of Law 44/2002 refers to, and not just by the loans and credits granted to those public bodies.

Question 17: Do you consider it appropriate to allow «cédulas territoriales» to be secured by debt securities issued by public bodies?

4.2.2. EXTENSION OF THE CATEGORIES OF PUBLIC BODIES.

The broadening of the categories of public bodies whose loans and credits can be used as collateral assets in *«cédulas hipotecarias»* could be envisaged. In particular, it could be interesting to include the loans and credits granted to all the public bodies article 56 of draft Royal Decree implementing Law 10/2014, June 26, on the organization, supervision and solvency of credit institutions, refers to. Said public bodies are the following:

1. *Autonomous bodies and public undertakings regulated in Title III of Law 6/1997 of 14 April, on the organisation and functioning of the General State Administration.*

2. *Other agencies or public law bodies linked to the General State Administration.*

3. *Managing bodies, common services and funds of the Social Security.*

4. *Instituto de Crédito Oficial.*

5. Autonomous bodies and public enterprises of the Autonomous Regions.

6. Public authorities or bodies of administrative nature, dependent on the Spanish local entities, provided that they are non-profit organizations.

7. Consortia composed of Spanish Autonomous Regions or local authorities, or by other public administrations, and in so far as, by reason of their composition, those public administrations bear most of the financial liabilities of the consortium.

Question 18: Do you deem it appropriate to extend the categories of public bodies in the terms proposed in this section? Would you add or eliminate any public body?

4.3. SMES AND SELF-EMPLOYED COVERED BONDS.

A possible way to improve the access to bank funding would be to facilitate credit institutions to refinance the loans granted to SME and self-employed by creating a new type of covered bond secured by this type of loans and credits. Still, for the new financial instrument to be effective, the assets included in the cover pool should be of high quality. Furthermore, it should be avoided that the same asset hedges simultaneously two different types of «*cédulas*».

Question 19: Do you think it would be advisable to regulate a new type of covered bond secured by loans and credits granted to SMEs and self-employed? If so, what assets could be used to secure the new type of covered bond?

5. LIQUIDITY MANAGEMENT.

Covered bonds, unlike securitizations, do not require an exact match between the cash inflows obtained from assets and the cash outflows to remunerate covered bondholders. Indeed, the issuer could cover the cash outflows with any element in their balance sheet. However, in order to strengthen the regulation and proper functioning of the covered bonds, it seems reasonable to establish mechanisms for the proper liquidity management of the issuances. In other European jurisdictions, there are three key mechanisms to manage liquidity: liquidity buffers, hedge derivatives and substitute assets.

Question 20: Do you deem it necessary to establish by law the existence of certain instruments to manage liquidity? If so, apart from the three mechanisms described above, do you believe there are other liquidity instruments it would be interesting to use in covered bonds issuances?

5.1. LIQUIDITY BUFFER.

Some jurisdictions require covered bonds issuers to have a dynamic buffer of liquid assets to cover their net cash outflows within a specific timeframe. However, there might be some kind of overlap between this buffer, the Liquidity Coverage Ratio (LCR) required by the CRR, and even with the substitution assets already foreseen for «*cédulas hipotecarias*» and «*cédulas de internacionalización*».

Question 21: Is it necessary to legally require a liquidity buffer? Should that be the case, what time horizon should the liquidity buffer cover? How could the overlap between the liquidity buffer for covered bonds and the LCR be avoided?

5.2. USE OF HEDGE DERIVATIVES.

Spanish law provides that the issuers should have adequate tools to cover inappropriate imbalances between inflows and outflows, and establishes the features the hedge derivatives linked to the covered bonds issuances should comply with.

Despite the aforementioned legal provision, it could be worth clarifying the conditions under which the hedge derivatives should be used by, for example, quantitatively defining when an imbalance is deemed inappropriate.

Question 22: Do you feel the need to further clarify the conditions under which hedge derivatives should be used? If so, what should they be?

5.3. SUBSTITUTE ASSETS.

One of the main novelties introduced by Law 41/2007, of 7 December, was to allow *«cédulas hipotecarias»* and *«bonos hipotecarios»* to be backed by substitute assets (the list of possible substitution assets can be found in article 17. 2 of Law 2/1981, of March 25) up to a limit, respectively, of 5% and 10% of total issuances. However, in other jurisdictions, the substitute assets could reach 15 % of the total issuance.

Given the fact that substitute assets increase the flexibility of covered bonds issuances and are the first assets to be sold should there be any liquidity mismatches, it could make sense to increase the percentage of substitute assets.

Question 23: Do you deem it adequate to increase the percentage of substitute assets to be used in issuance programs? Would you somehow extend the categories of substitute assets?

6. TRANSPARENCY.

Transparency requirements for covered bonds issuers show significant differences in the different EU regulatory frameworks. In this respect, issuers themselves have sought to establish common standards as, for instance, the *Covered Bond Label* of the *European Covered Bond Council*.

Irrespective of the accession by Spanish issuers to such initiatives, it could be desirable to introduce a greater degree of harmonization in the information submitted by the issuers, as a way of improving the resilience of the financial sector as a whole.

Moreover, not only is this information useful for covered bondholders, but also for the rest of the creditors of the credit institution, as the vast majority of them have a lower priority status in case of insolvency.

In order to improve the quality of the information provided by the issuers, different measures could be considered.

For instance, the information issuers provide on the cover pool assets could be revised. In this sense, it should be considered whether such information should be provided on a loan-by-loan basis or on a layered basis. Whilst layered information would help investors have a very clear and quick idea about the situation of the cover pool, loan by loan information would offer a more accurate picture. Therefore, it seems it would be appropriate to find the right balance between detail and aggregation.

Question 24: On what subjects and how frequently should issuers provide information? With what level of disaggregation should this information be presented? Through what means should this information be made public?

Moreover, one of the best practices identified by different financial actors is the performance of stress tests to assess the capability of the cover pool to generate enough inflows to meet future outflows. Thus, it would be useful for issuers to evaluate the response of their issuance programs to different risks such as credit risk, market risk and liquidity risk.

Question 25: Do you deem it appropriate to make issuing institutions perform stress tests to assess the capability of the cover pool to generate enough inflows to meet future outflows? If so, what type of risks should those stress tests take into account? How and with what periodicity should those stress tests be performed? What type of information should be made public?

7. ASSET POOL MONITOR.

It could be interesting that the truthfulness of the information provided by the issuing institutions was confirmed by an external and independent agent. This figure already exists in some European jurisdictions under the name of the Asset Pool Monitor.

The duties of the Asset Pool Monitor vary considerably from country to country. However, there seems to be a common core of functions, namely:

- Verification of the selection process of the assets to be included in the cover pool.
- Verification of compliance with the issuance limits.
- Regular reporting on the compliance by the issuer with legal requirements, on the quality of accountability, on the volume of errors detected and on the deficiencies in the information systems. Said reports should be sent to the supervisory authority and, when the information is not sensitive, they should also be made public.
- In the case of «*cédulas hipotecarias*», verification of the correct updating of the collateral of the mortgage loans.

Question 26: Do you deem it appropriate to legally foresee the figure of an Asset Pool Monitor? If so, what duties should she be charged with?

In view of the importance of the basic tasks to be assigned to the Asset Pool Monitor, it would be reasonable that those tasks were performed by entities fulfilling two conditions: (1) entity with sufficient technical/financial knowledge and enough means to develop the role with solvency and reliability; (2) entity placed under a system of public authorization and supervision.

Question 27: Depending on the tasks you believe should be performed by the Asset Pool Manager, what type of entity do you believe would be best placed to develop those tasks? Who should appoint the Asset Pool Manager?

8. OTHER ISSUES TO CONSIDER.

8.1. *«BONOS HIPOTECARIOS»* AND *«BONOS DE INTERNACIONALIZACIÓN»*.

Apart from the *«cédulas»*, the Spanish legislation foresees two additional figures of covered bonds: *«bonos hipotecarios»* and *«bonos de internacionalización»*. Despite the fact that in the case of *«bonos de internacionalización»* the recent approval of its regulation has prevented the verification of the success of this figure, the issuance volume of *«bonos hipotecarios»* has been very reduced.

In this context, the legal framework of these figures could be revised in order to keep a type of covered bond whose cover pool assets could differ from those included in the cover pool of *«cédulas»*. In any case, it should be taken into account that the new securitization legal framework foreseen in the draft Law on the Promotion of Business Funding would allow the synthetic replication of the figures of *«bonos»*.

Question 28: What advantages do the figures of «bono hipotecario» and «bono de internacionalización» offer? What changes to their legal framework are necessary to increase their attractiveness?

8.2. OTHER FINANCIAL INSTRUMENTS IN THE MORTGAGE MARKET.

In addition to *«cédulas hipotecarias»* and *«bonos hipotecarios»*, credit institutions issue other types of financial instruments of the mortgage market in order to get funding. In this sense, *«participaciones hipotecarias»* and *«certificados de transmisión de hipoteca»* could be highlighted. It might make sense to extend some of the improvements foreseen for covered bonds to these financial instruments.

Question 29: Would you extend any of the measures foreseen in this document to «participaciones hipotecarias» and «certificados de transmisión de hipoteca»? Do you deem it necessary to adopt any additional measure in relation to these financial instruments?

8.3. POTENTIAL IMPACT OF THE REFORM OT THE REGULATORY FRAMEWORK OF COVERED BONDS ON ISSUERS AND INVESTORS.

The measures that could be adopted to revitalize the legal framework of covered bonds would be of great breadth and depth, thereby generating a significant impact on issuers and investors. This suggests the need to think whether this reform should only be applicable to new issuances or, alternatively, whether a transitional period should be foreseen to allow operators to adapt to the new rules.

Question 30: What impact do you believe the measures proposed in this document could have on covered bonds issuers? And on investors and other market participants? Do you think the new regulation should only apply to new issuances or a transitional period for adaptation would suffice? What should the duration of that transitional period be and how should it operate?