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Position of the European Financial Congress[1] in relation to the European Commission's consultation document Covered Bonds in the European Union[2]

Methodology for preparing the answers

The answers were prepared in three stages:

Stage 1

A group of experts including more than 80 specialists were invited to participate in the survey. They received the executive summary of the project and selected consultation questions including summaries of the key parts of the EC consultation document (all in Polish). The experts were guaranteed anonymity.

Stage 2

The Gdańsk Institute for Market Economics[3] received 29 opinions (from individual experts, expert groups and institutions). All the responses were collected, anonymised and presented to the experts who took an active part in the consultations. The experts were asked to mark in the other consultation participants' opinions the passages that should be included in the final position. Experts could also adjust their positions under the influence of arguments by other experts that they had not known previously.

Responses were obtained from experts representing:

- universal banks and mortgage banks,
- pension funds, investment funds and insurance companies,
- regulatory bodies - financial supervision authority and central bank,
- consulting firms,
- the academia.

Stage 3

On the basis of the responses received the survey project coordinators from the European Financial Congress prepared the final version of the European Financial Congress's answers.

[1] European Financial Congress (EFC – www.efcongress.com). The purpose of the regular debates held within the EFC is to ensure the financial security of the European Union and Poland.

[2] www.ec.europa.eu/finance/consultations/2015/covered-bonds/docs/consultation-document_en.pdf

[3] Instytut Badań nad Gospodarką Rynkową (IBnGR) – the first independent think tank in Central and Eastern Europe, founded in 1989 by a group of economists associated with the democratic opposition and the "Solidarity" movement.

Answers of the European Financial Congress to selected consultation questions

PART I – Covered bond markets: economic analysis

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

   YES

1.1 If so, what where the key drivers of this convergence/divergence?

The main causes of the growing divergence between covered bond yields after 2007 include:

- **different perception of the financial stability of individual countries;**
- **quality of banking systems in terms of credit and liquidity risks;**
- **risk related to the level of debt of individual countries;**
- **credit quality disparities between Member States;**
- **differentiation of sovereign bond yields between Eurozone countries;**
- **diversity of legal and organisational settings, in particular insolvency-related issues, lack of confidence in not fully transparent legal systems, which intensifies significantly at times of increased risk aversion;**
- **alignment of covered bond yields with sovereign bond and unsecured debt yields (reduced country rating translates indirectly into reduced rating of covered bonds originating in that country);**
- **quality of cover assets;**
- **diversified perception of covered bond risk in national markets;**
- **ECB's UCITS mechanism, which has driven down covered bond yields.**

Please provide evidence to support your view on the possible convergence and divergence of pricing conditions in European covered bond markets before and after 2007 respectively:

Indeed, at first covered bond yields on the European markets tended to converge (before 2007), but then started to diverge. Initially the disparities were insignificant (2007–2009) and then deepened after the onset of the public finance crisis in the Eurozone (in 2009). The trend reversal occurred after the market peak in 2007 and under the influence of the global financial crisis in 2008, as a result of which, at first, investors generally moved away from structured instruments (their selling-off, dipping prices and growing yields). Another factor was the subsequent debt crisis in the Eurozone, when sovereign bond yields of non-core countries (especially PIIGS – Portugal, Italy, Ireland, Greece and Spain) soared compared to the yields of benchmark bonds (chiefly German bunds), which was reflected (on various scales) by the yields of covered bonds issued in those countries. The situation started to stabilise gradually only after the ECB announced its covered bond purchase programme in the second half of 2009.

The intensity of the covered bond yield divergence process differed from country to country. The highest yield increases were observed in southern countries: Portugal, Spain, Italy and France, and the lowest in Germany and Sweden. This resulted from the fact that investors were less concerned about the condition of the German economy and legislative differences.

source: iTRAX Covered Bond, VDP, Bloomberg and HSBC.

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

Yes

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

Yes

2.3 Where there any other reasons?

Yes

Please explain your answers to question 2:

The yield differences result from the diversity of covered bond markets and are understandable given the risk incurred by covered bond investors in individual countries, but are also attributable to other reasons, including market factors (market size and liquidity, domestic investor base), security of national legal settings, which directly translate into an increase of covered bond ratings and a decline in the quality of the cover assets. Differentiation of markets was not the main reason behind the yield divergence. The divergence was mainly caused by disparities between Member States in terms of the investment risk associated with specific countries. Country ceilings are among the key barriers to yields. The German market clearly stands out, as it remained stable even during the crisis and was characterised by low variations. The yield of German covered bonds has remained several base points below the quotations of 5-year debt under AAA-rated issues. The lowest level in history was achieved thanks to considerable involvement of the ECB, which buys, on average, 40% of covered bond issues on the primary market. Despite the decreased supply (with the highest level in history recorded in 2012), the number of investors interested in negative yields has been on the decline. Investors perceive covered bonds in terms of the country risk, which translated during the Eurozone debt crisis into credit spread widening for covered bonds of non-core countries relative to Germany/Scandinavia. As it seems, the credit risk premium of the issuer's country is the starting point for covered bond risk valuation, and despite the protective mechanisms provided for by law, investors assess the risk of significant losses in case of sovereign default. An important role was played by the risk of Eurozone breakup according to the following sequence: sovereign default -> inevitability of Eurozone exit -> strong currency devaluation and associated capital losses by investors in covered bonds.

Two elements were crucial for the divergence of covered bond markets. Firstly, the quality of legislation. It was a wide-spread view that the model with a separate category of mortgage banks (in Germany, despite the changes introduced in 2005, specialised banks were the predominant issuers) better secures investors' interests. Another very important element was the expected impact of the crisis on the economy and thus on the real estate market. Investors were concerned about the situation e.g. in Spain, where the downturn of the real estate market was so serious that even very strict legislation seemed unable to fully secure investors' interests.

Covered bonds were treated by investors as a substitute of government bonds, which could be felt in the countries where the risk of a public finance crisis was considered high. The market set aside a group of stable countries and narrowed the spread. One could observe disproportionate discrepancies between the yield of e.g. German *Pfandbriefe* and instruments issued in non-core countries. At the turn of 2014/2015, when the market was already considered to be stable, the spread between the Eurozone countries perceived as secure and the peripheral ones narrowed considerably. The current legal frameworks in the individual Member States differ in terms of security levels for investors. Notably, when the crisis intensified, investors' evaluation focused on the financial position of the issuer's country and the condition of its banking sector. Such elements as the cover quality and establishing a register of cover assets acquired secondary importance, as did the legal framework.

Some other causes which led to the divergence on the covered bond market include:

- **increased differences in investors' approaches to the risk associated with sovereign debt levels;**
- **The downturn of the real estate market in some countries caused the valuation of real estate (cover assets) to be highly problematic, because it was, among other things, impossible to assess the enforceability of the cover and estimate the impact of the sale of the portfolio on prices;**
- **growing liquidity requirements among covered bondholders, which are different from country to country and from investor to investor, as well as liquidity differences between various cover bond markets, as a consequence of which the greater the market pricing shift, the less liquid the market;**
- **division of the market according to the ECB eligibility criteria.**

PART II – Exploring the case for a more integrated framework

1.1 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?

Yes

1.2 Are there any advantages or disadvantages to this initiative other than those described in section 2 of Part II?

Yes

Please explain your answers to question 1:

A more integrated legal framework for covered bonds could certainly improve the comparability of issues originating in various countries and reduce moral hazard. The system applied currently under CRR requires information from the cover bond register to be provided. A Cover Pool Report is published by issuers at least twice a year, but there are significant differences e.g. in the LTV calculating method, as a result of which reports from different countries are incomparable (e.g. Germany applies a different LTV calculating method, which is more beneficial for issuers than that used in Poland). There are different models of mortgage banks on the market: universal, specialised banks, and SPVs, and furthermore, there are different local limits for LTV and the register and methods for limiting assets in the register. Some jurisdictions limit the territory where the covered real estate can be located to a single country, for others the territory includes all Europe, and for some of the most liberal ones – the whole world.

A more integrated legal framework for covered bonds could improve market liquidity. This is a major area for improvement and difficult to be achieved on account of the huge legal differences. Shortened issuance process and simplified bond settlement between clearing houses across borders would reduce system costs (clearing houses, stock exchanges) and would facilitate trade. Currently, market liquidity proves to be increased only for the first six months after issuance. Later, even the liquidity for Jumbo issues (issues in excess of EUR 500 million) is not satisfactory. It so happens that the largest *Pfandbriefe* issues do not record a single transaction on the secondary market. The highest secondary trade is observed for the Spanish *Cedulas*. Transaction values are low – up to EUR 5 million. The underlying reason is the high margin attracting short-term capital. Due to excess liquidity on the market investors are unwilling to get rid of their securities, which is a major reason behind the non-liquidity.

A more integrated legal framework for covered bonds could foster issuance and foreign investments. Regulations in this respect should be eased, but exploring the potential for foreign investment should remain an individual economic choice. Currently, peripheral markets owe their potential for growth mainly thanks to the low margin in Germany (main investor). This has been the case in recent years in Australia, New Zealand, and the Czech Republic. In order to attract buyers to Poland it is necessary to increase issuance volumes.

A more integrated legal framework for covered bonds could be particularly beneficial for smaller countries, expanding significantly their pool of investors. At present, smaller countries resort to issuance in other jurisdictions (e.g. in December 2014, RCB Czech Republic issued covered bonds amounting to EUR 500 million). Increasing issuance volume is necessary to activate

investors. Allowing cross-border issuance disproportionately increases the group of potential buyers.

By putting in place the same regulatory standards, a more integrated framework could improve investor confidence and allow covered bonds to be treated in a consistent way as liquid assets when calculating LCR, even though, as it seems, the rating of at least two reputable rating agencies will remain crucial.

A more integrated legal framework could contribute to increasing the pool of covered bonds available for outright transactions. If central banks followed the example of the ECB and bought covered bonds, certainly this would improve issuance efficiency and confidence in the market by stabilising the market. At present, Polish covered bond issuance is not significant in volume terms relative to sovereign debt.

A more integrated legal framework could improve investor confidence, and consequently reduce high overcollateralisation levels, even though for countries where the level of overcollateralisation results from the country risk rather than portfolio or issuer risk, reducing overcollateralisation levels may not have a positive effect on investor confidence and may disrupt the functioning of the covered bond market.

Indeed, covered bond market harmonisation is a huge challenge, in particular when there is a need for direct application of the directive, and would involve substantial regulatory risk for the countries where the market has already been regulated in detail and changes could disrupt its current operation. Standardisation can also affect the flexibility of offerings. Often individual series of covered bonds tend to be targeted at specific, narrow groups of investors. It is extremely difficult to put together several systemic solutions that have worked well for many years with such significant issuance volumes outstanding on the market. Harmonisation of the covered bond market will not have a negative impact as long as it does not modify substantially the foundations underpinning the success of the best-perceived and best-developed markets (including the German one). At present, covered bond issuance is regulated in different ways at Member State level (specialised banks, universal banks, SPVs) and, in each case, a cover pool for covered bond issue represents a segregated insolvent estate and is used first to satisfy the liabilities arising from covered bonds. As a rule, these solutions work well and, to date, no covered bond issuer has ever become insolvent. The solutions have many things in common and keep being refined, as is exemplified by recent revision of the Polish Act on covered bonds and mortgage banks and the Bankruptcy and Reorganisation Law. Thus it all depends on how the proposed changes will be implemented in EU and Member State legislation. However, it must be pointed that standardisation may reduce investor base, since currently investors can choose from various covered bond structures (hard bullet, soft bullet, conditional pass-through),

which allows addressing their various investing needs. This year, Poland introduced major changes to its covered bond regulations, which should allow the market to grow fast. Introducing further changes that could be inconsistent with recent developments could disrupt mortgage banking development in Poland and disturb the functioning of the market. Irrespective of previous experience of a given market in covered bond issuance, by introducing changes – which should be done with caution – the proposed integration will cause certain disruptions across the jurisdictions, yet in the long run, the expected benefits should markedly outweigh the costs.

Benefits:

- **product integration has a positive effect on market growth;**
- **reduced costs, improved portfolio diversification opportunities for investors, increased importance of peripheral markets;**
- **simplified cross-border investing, reducing organisational and financial burden for investors, both retail and professional, and allowing investors to analyse investments, within reasonable time frames, in economic and legal terms (at least, to verify the minimum formal and business requirements), and thus take informed investment decisions;**
- **providing issuers a relatively level playing field in terms of access to European markets, the structure of covered bonds and clearing methods, e.g. for all covered bonds denominated in EUR to have the status of ECB eligible.**

Disadvantages:

- **defective implementation may weaken the covered bond markets that are currently functioning well;**
- **need to change existing practice and align regulations and practice to new requirements, as well as create new (and more) regulation;**
- **period (waiting time) required for the targeted legal framework to put in place, non-precision of regulation, extra bureaucratic costs;**
- **limited availability for small and peripheral markets;**
- **risk that not every country will be able to adapt to the harmonised model given the size of their issuance and legislation (e.g. bankruptcy law, housing law, etc.);**
- **the solution implemented may be a „resultant" one, in which nobody will be privileged, but everybody will be underprivileged.**

3. 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?

   Yes

3.1 If so, which of the options suggested in section 3 of Part II should the Commission follow to that end and why?

Option 1: Subsidiarity and indirect harmonisation

Please explain why you think the Commission should follow the options you selected in order to enhance standards and promote market integration:

It seems that the indirect harmonisation option is a better solution because:

- **it is more feasible since the other considered option would require introducing uniform EU legislation in a range of areas and with respect to supporting institutions, not only the area of covered bonds, and full standardisation would be difficult to achieve;**
- **the model seems more realistic as it would not require full and complicated standardisation and unification given in a situation of the present-day diversity of market development levels within the EU;**
- **on the one hand, such a solution would allow introducing a pan-European pool of instruments based on harmonised provisions adopted through self-regulation based on recommendations (e.g. issued by the EBA), and on the other, it would allow retaining domestic pools of instruments, based on local regulations and perhaps better reflecting the specificities of individual markets, which may be required both by some investors and issuers;**
- **at least initially, harmonisation should take place through voluntary compliance of individual countries, since introducing the proposed changes through recommendations would allow preliminary assessment of the impact of such changes on the individual markets, and importantly, would allow countries to comply gradually depending on the maturity of their domestic markets and the scope and character of their national regulations (the European Commission could issue recommendations to Member States to implement the EBA's best practices in their national legal frameworks).**

PART III – Elements for an integrated covered bond framework

2. Covered bond issuers and system of public supervision

2.1 Issuer models and licensing requirements. Role of SPV's

1.1 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?

Yes

1.2 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?

The CRR and CRD prudential requirements seem to be sufficient as a condition for licensing covered bond issuers.

Please explain your answers to question 1:

The licensing system should be simplified to require a one-off authorisation for all covered bond issuers based on common high level standards, on condition that it is available to various categories of issuers (including specialised banks when such banks operate under national legal frameworks) because:

- **clear and high standards guarantee market transparency;**
- **simpler solutions are verified by the market in a faster way;**
- **the process will be shortened, which should foster covered bond issuance.**

EBA clearly prefers the SPV model as the most effective and simplest one, meanwhile Poland applies a system of specialised banks. There are no reasons why common standards should not be put in place for all issuers, on condition that they can be met by the various categories of issuers (including specialised banks when such banks operate under national laws).

2.2 On-going supervision and cover pool monitoring (pre-insolvency)

1.1 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?

Yes

1.2 What specific duties and powers should be included in the Framework and/or EBA or ESMA Guidelines?

Proposed common duties and powers of competent authorities with respect to the supervision of covered bond programmes and issuers in the context of the new legal framework for covered bonds:

- **detailed licensing procedure, obligatory approval of valuation of the mortgage cover assets rules, activity of an independent cover pool monitor;**
- **rules for and frequency of valuation of the mortgage cover assets (with the aim of harmonising the approaches used) and cover pool management rules;**
- **cover asset qualification criteria, asset cover valuation review, cover asset register monitoring, review whether liabilities under an issue are covered**

by registered assets, authorisations to complete regular checks and inspections;

- **tools for monitoring and rules for controlled insolvency and team of covered bond creditors.**

Please explain your answers to question 1:

The common duties and powers of competent authorities for the supervision of covered bond programmes and issuers should be viewed positively because they would:

- **allow aligning supervision levels and improve the possibility of its review;**
- **simplify licensing and market control procedures;**
- **improve overall sector security, and introducing harmonised rules would establish uniform practice;**
- **be a natural continuation of covered bond issuance legal framework standardisation providing better guarantee such arrangements are complied with;**
- **improve the confidence of investors from other Member States than the issuer's country, while improved trust in local supervisory mechanisms will enhance market efficiency.**

2. 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?

- **a requirement on the issuer or the competent authority to appoint an independent third party as monitor of the cover pool:**

  Yes

- **professional eligibility criteria that a person or legal entity should meet to be appointed as cover pool monitor:**

  Yes

- **specific duties and actions that the cover pool monitor would be bound to and his/her/its liability:**

  Yes

- **a European passporting mechanism that would allow cover pool monitors to offer their services in other Member States:**

  Yes

Please explain your answer to question 2:

On establishing and legal regime of the cover pool monitor, requiring the issuer or the competent authority to appoint an independent third party as monitor of the cover pool would be a positive solution, enhancing investor confidence. In Poland, the responsibility for making entries into the register of covered bonds and for limits supervision is entrusted to an independent trustee (there is no need to duplicate the role). Entry and deletion reports are provided to the Polish Financial Supervision Authority on a monthly basis. Furthermore, under the new legislation that enters into force on 1 January 2016, a trustee will monitor liquidity tests, which check interest coverage, and overcollateralisation tests, which verify whether adequate capital is guaranteed. The solution seems to reflect the essence of the recommendation. An independent trustee guarantees proper assessment of the receivables that underlie the liabilities to be settled under covered bonds. In addition, investor security is improved by independent third-party monitoring. Currently, Polish banks enjoy substantial freedom in valuation of the mortgage cover assets rules, which may lead to differences in valuation standards between issuers. Extending the role of the trustee in this respect would result in harmonisation of valuation standards.

On establishing and legal regime of the cover pool monitor, the requirement for a person or legal entity to be appointed as cover pool monitor to meet professional eligibility criteria should be viewed positively because:

- **the role requires having specific minimum qualifications, including graduation from legal or economics studies, market practice or real estate valuation skills;**
- **eliminating persons or entities providing no guarantee that such monitoring will be carried out in a professional manner increases the security of instruments and investors.**

On establishing and legal regime of the cover pool monitor, the requirement for the monitor to perform specific duties and actions subject to liability would be a positive solution. The monitor should focus on assessing and caring about the receivables in the cover pool and the real estate valuation method. A list of minimum cover pool monitor duties and actions should be compiled, which – combined with making his/her/it liable for monitoring quality – would improve safeguards for investors investing in such instruments. This would foster market confidence and streamline cross-jurisdiction issue assessment. The results of monitoring would be more comparable for investors.

On establishing and legal regime of the cover pool monitor, the introduction of a European passporting mechanism that would allow cover pool monitors to offer their services in other Member States would be a positive solution because:

- **broader opportunities for providing such services would be conducive to exchange of experience and applying the same good practices across the EU;**
- **it increases the comparability of the monitoring results between countries/markets.**

3. Dual recourse and insolvency/resolution regime

3.3 Administration of the cover pool post insolvency/resolution of the issuer

3.3.1 Legal form and supervision of the cover pool

2. Who should be the supervisory authority for these purposes, the competent authority or the resolution authority?

Even though both methods enjoy equal support, as it seems, the supervision over a cover pool in the event of the issuer's insolvency or liquidation should be entrusted to the resolution authority. The arrangement adopted by the amended Polish Bankruptcy and Reorganisation Law should be maintained for the part governing mortgage banks. The role of the resolution authority is performed by a liquidator.

3.3.2 Special administrator of the cover pool

1. 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?

The special administrator should be a licensed insolvency practitioner because this:

- **guarantees that the person will be duly prepared for performing his/her task;**
- **ensures the required in-depth knowledge of procedures to achieve maximum cover pool security and avoid risk of claims (from unsecured investors) as a result of possible procedural errors;**
- **facilitates cover pool administration and efficient liquidation.**

The special administrator should be appointed by and accountable to the insolvency court, and the supervisory authority or resolution authority should have a role in this process. There should be an authority that will control and supervise the activity of such a person. Such an institution should have the right to be heard or put forward a candidate for appointment.

A special administrator's primary duty should be to act in the interest of the bondholders with the objective of satisfying them in full with the cover pool. This is a key prerequisite for covered bonds to be considered a secure

instrument from investors' perspective. A special administrator should act in accordance with the dual recourse principle to settle in full the liabilities towards investors (i.e. first by having recourse to the cover pool and then the issuer's overall assets should the pool prove insufficient).

A special administrator, similarly to a liquidator under Polish law, should have a range of powers which should be adequate and sufficient to carry out his or her primary task, i.e. acting in the interest of the investors with the objective of settling in full the liabilities of the cover pool. It is necessary to grant special administrators appropriate powers so as to ensure that their activity and investor protection are effective. Otherwise the risk of claims from e.g. unsecured creditors will grow.

Where national laws entrusts the powers of a special administrator to a liquidator, the above should apply to the liquidator.

2.1 Should the special administrator be obliged to report regularly to the relevant supervisory authority?

Yes

2.2 Should the content and regulatory of such reporting be the same as for the issuer?

Yes

Please explain your answers to question 2:

The special administrator should be obliged to report regularly to the relevant supervisory authority and the content of reporting should be the same as for the issuer because this:

- **improves the transparency of the supervisory process and data consistency;**
- **allows the administrator's actions to be supervised and controlled on an on-going basis;**
- **allows supervision continuity to be maintained, which is crucial in crisis situations (default);**
- **from investors' point of view, the liquidator as if assumes the previous role of the issuer and is to cause (subject to the same supervision from competent authorities) the issued instruments to be repaid using the segregated cover assets;**
- **improves exchange of information between the parties involved in the process in the event of the issuer's insolvency or liquidation, which always involves the risk of financial market disruption.**

4. The cover pool

1.2 Should certain riskier residential or commercial loans (ie 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?

No

Please explain your answers to question 1:

Riskier residential or commercial loans (e.g. buy-to-let mortgages; second home loans; loans to real estate developers) <u>should not</u> be excluded from the cover pool, even when worse loan repayment performance has been proven empirically. Furthermore, this will also enhance the growth of such activity and improve cover pool diversification.

Such loans may be accepted under the following conditions:

- **investors should have full information about cover pool composition: the requirement for securing such assets should be suitably calibrated, taking into account both the LTV ratio and the required overcollateralisation level; it is suggested that a limit should be introduced in the form of a maximum share of such assets in the cover pool and that such instruments should be made available to professional investors only;**
- **the share should be transparent and clearly communicated to the investor, and reflected in adequate rating or/and increased level of security;**
- **their amount/share should be suitably limited, e.g. for commercial loans such additional security is (already) provided by maximum LTV, and loans for real estates under construction, e.g. developers' projects, may represent only a specific small percentage of the portfolio;**
- **the valuation of the mortgage cover assets parameters of such loans should be accordingly adjusted, taking into account the additional risk;**
- **the primary criterion, irrespective of the real estate type, should be the mortgage entered in the mortgage register as the first one (first ranking mortgage). Funding level differentiation may be introduced, too, as is, for example, the case in Poland for housing real estates (80% of the valuation of the mortgage cover assets), and commercial real estates (60% of the valuation of the mortgage cover assets);**
- **the legal solutions should allow riskier housing loans and commercial loans to be assigned to separate cover pools so that assets of different classes and quality are not mixed.**

4.1.3 Other assets: Aircraft, Ship and SME loans

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

   Yes

   Please explain your answers to question 1:

   The new legal framework should exclude aircraft, ship and SME loans from cover pools because:
   - **a cover pool should be homogeneous and standardised;**
   - **these groups of assets are characterised by different risk parameters than real estate;**
   - **the above assets represent a class so different from the broad category of real estate that they should underlie issuance of separate instruments;**
   - **they are not significant in the portfolios even in Germany and Luxembourg, and are not permitted as cover structures in Poland.**

2. 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?

   Do not know

   Please explain your answers to question 2:

   There is a difference of opinion as to the possibility of identifying a category of prime SME loans that could qualify as eligible assets for cover pools.

   On the one hand, it is positive on assumption that:
   - **they can be identified based on their intended purpose, internal ratings, size;**
   - **a separate cover pool and a separate instrument under another trade name can be identified (SME with specific risk rating, e.g. internal rating);**
   - **the types and intended purpose of the real estate that can serve as a security are specified; the maximum share of such loans in the cover pool is to be considered, too.**

   And on the other hand:
   - **it is a riskier class of assets;**
   - **SME loans are secured in other ways than loans granted for the purchase of real estate, and therefore, even though identifying a prime loan category within that class of loans and issuance of securities similar to covered bonds is possible, such instruments should not be named covered bonds;**

- **if the Report refers to all SME loans and not only to mortgage-backed loans – assuming this, one cannot accept the proposal for SME loans to underlie issuance of covered bonds.**

4.1.4 Mixed pools and limits on exposures

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

No

Please explain your answers to question 1:

Mixed pools should not be allowed because:

- **this would hinder risk assessment and maintaining a high-quality pool;**
- **a cover pool should be homogeneous and standardised;**
- **the idea underlying covered bonds is that cover assets are homogeneous, meanwhile mixed assets may cause loss of instrument transparency, lack of comparability, and consequently, problems with valuation and finding investors;**
- **the homogeneity of cover assets increases the clarity and transparency of the instruments they underlie; the security of such instruments should be achieved by diversification within a group of assets, and not diversification between different groups of assets;**
- **cover pools should be highly homogeneous and may not comprise such highly-differentiated cover assets because of the different risks involved and problems with selling assets linked to other countries;**
- **such a solution does not fit into the category of cover assets and risk profile associated with the product (the covered bond category should not be extended towards quasi-securitisation because this could lead to speculation bubbles);**
- **for those asset groups separate and not mixed pools should be created;**
- **investors willing to obtain such a mix may add securitised assets to their portfolios, otherwise a mortgage bank would cease to be a specialised unit.**

4.2.2. Overcollateralisation

1. Should a quantitative mandatory minimum OC level be set in the Framework?

Yes

1.1 If a quantitative mandatory minimum OC level should be set in the Framework, what should that level be and should it be the same for all types of covered bonds?

The minimum obligatory overcollateralisation level should be established which should:

- **depend on the pool class and risk and covered bond type, with an option for it to be raised under national legislation and subject to a requirement that the level must be calibrated based on the LTV ratio and additional quantitative analyses in all Member States;**
- **rating agencies expect minimum overcollateralisation according to rating tables (as from January 2016, overcollateralisation rate in Poland will amount to 10% and will be among the highest levels provided for by legislation);**
- **the 10% applied in Poland could be used as a reference when discussing the uniform recommendations (e.g. at least 10% for mortgage covered bonds and 3% for public covered bonds) .**

3. Should the Framework set a maximum level of permitted OC?

No

Please explain your answers to question 3:

The maximum permitted level of overcollateralisation should not be set because:

- **the freedom to set the maximum level gives issuers resilience under market stress, when investor confidence – and thus the demand generated by investors – decline;**
- **each issuer aligns its overcollateralisation level to the rating it wishes to achieve;**
- **such a solution will allow issuers to be in greater control of the cost of the capital they raise taking into account the LTV ratio;**
- **higher overcollateralisation levels are welcome by investors and rating agencies;**
- **this should be regulated by market practice, but being a pricing factor, excessive overcollateralisation may have a negative impact on market growth.**

There is no reason for a cap to be introduced for those jurisdictions where covered bonds are issued by specialised banks, and thus there is no need for „non-privileged" creditors to be protected in case of the issuer's insolvency. If such a cap proved to be required in jurisdictions where covered bonds are issued by universal banks, its level and rules governing it could be set at Member State level. In Poland covered bonds can be issued exclusively by mortgage

banks, as a result of which the risk of excessive encumbrance of other assets is not so significant as for other countries with different legal settings.

4.3 Cover assets/liabilities risk mitigation: market and liquidity risks

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

Yes

4.1.1 Please explain in what circumstances should covered bond issuers hold a "liquidity buffer" to mitigate liquidity risk in the cover pool:

Issuers should always hold a liquidity buffer for crisis situations to mitigate the liquidity risk of the cover pool.

Please explain your answers to question 4.1:

Issuers should always hold a liquidity buffer because:

- **liquidity risk arises out of mismatches between the flows on the asset and liability sides, and manifests itself most strongly under bank or covered bonds insolvency conditions;**
- **it may be useful in the event of interest rate mismatches, currency mismatches or other operating, legal or tax risks;**
- **a liquidity buffer should secure timely settlement of the cover pool, including when the issuer declares its insolvency, and Polish arrangements in this respect require mortgage banks to hold surplus collateral of no less than the aggregate amount of nominal interest on outstanding covered bonds payable within the next 6 months;**
- **the amount of liquidity buffers should adequately reflect the structure and activity of the bank (group of banks) to minimise the consequences of possible legal, regulatory or operational barriers to the use of the buffer assets;**
- **holding a liquidity buffer by the issuer seems reasonable in the context of the need to meet the liquidity standards by financial institutions under the CRDIV/CRR regime;**
- **this is required by agencies to achieve suitable rating.**

4.2 Should the buffer be calibrated to cover the cumulative net out-flows of the covered bond programme over a certain time frame?

Yes

4.2.1 What length of time should be used as a time frame for calibration purposes?

It seems reasonable for the liquidity buffer to be fixed at a level equivalent to at least the amount of nominal interest of outstanding covered bonds payable within the next 6 months (as in Poland).

Please explain your answers to question 4.2:

The liquidity buffer should be at least equal to the total net outflows under the cover bond programme within a specific time frame, which should depend on the characteristics of the issue, i.e. longer coupon periods should result in longer liquidity buffer periods.

4.3 What eligibility criteria should liquid/substitution assets meet to qualify for the purposes of this buffer?

For them to qualify for the liquidity buffer, liquid/ substitution assets should meet the following criteria:

- **represent low-risk and top-liquidity assets with absolute priority so that the issuer's difficulties disclosed to the market do not prevent the assets from being sold;**
- **be cash equivalents / short-term debt instruments and comprise: cash, funds pledged to the central bank or funds invested in securities issued or guaranteed by: The European Central Bank, the Organisation for Economic Cooperation and Development, governments or central banks of EU Member States (excluding countries which are restructuring or restructured their foreign debts at a specific point in time);**
- **may comprise cash and assets recognised by the central bank as collateral and are highly liquid on private markets (a wider range of liquid assets in the buffer is acceptable on condition that the bank demonstrates its ability to use them to generate liquidity within a specific time frame under stress);**
- **have a high rating and transparent secondary market;**
- **be consistent with the definition of liquid assets specified under CRD IV and the definitions used when setting the LCR and NSFR.**

5. Transparency requirements

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

Covered bond issuers should make disclosures to investors on a quarterly basis.

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

Yes

Please explain your answers to question 4.1:

The above scope of reporting is granular enough. The above information are published in a Cover Pool Report, which is considered a standard data set. Roadshows always provide an opportunity for answering more questions, and such a formula is sufficient. Furthermore, issuers should be subject to a disclosure regime, just like listed companies, e.g. regarding publishing financial statements.

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

Yes

Please explain your answers to question 4.2:

The above scope of reporting does not require additional legislative support to provide broadened and coherent disclosures within the framework of the European covered bond market. The scope of information presented allows risk assessments to be conducted in line with EBA guidelines.