Helaba Research

COVERED BOND SPECIAL

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Implementation of EU covered bond harmonisation package: Little change to the Pfandbrief

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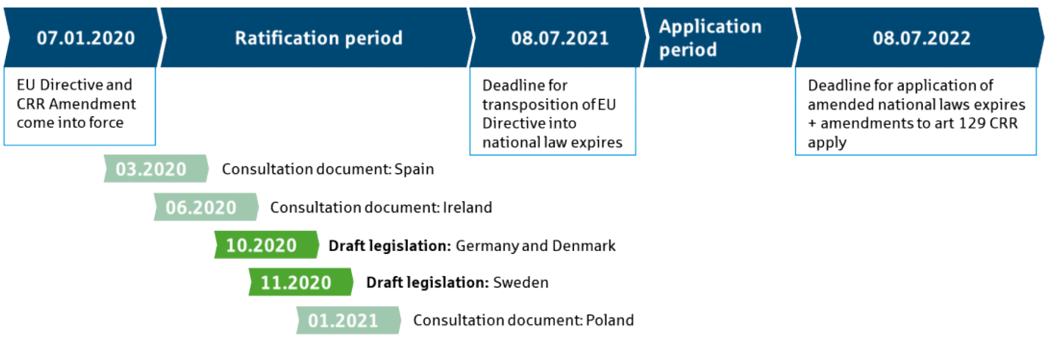
- New EU regulations on the harmonisation of covered bonds across Europe must have been transposed into national law by 8 July 2021 and come into force for all issuers a year later. Germany launched the process of adopting the necessary changes in the Pfandbrief Act 2021 (PfandBG) at an early stage and is on track to meet the deadline.
- The government's draft legislation on amending the existing PfandBG contains a modest number of adjustments, since many of the mandatory provisions of the EU's harmonisation package have long been standard features of Pfandbriefe. However, the amendment does include some stricter requirements, such as the blanket bank on the inclusion of receivables from credit institutions from the same banking group as the issuer in the cover pool.
- By introducing maturity extensions, German lawmakers have opted to provide an additional instrument to mitigate liquidity risks in the event of a crisis. Extending the maturity of Pfandbriefe by a maximum of 12 months is considered a last resort by the cover pool administrator to alleviate liquidity constraints. In conjunction with the 180-day liquidity buffer, these dual safeguards provide considerable protection for investors and mean that Pfandbriefe are a cut above international standards.
- However, there is still a risk that the liquidity buffer may be weakened as issuers' associations are seeking changes in the calculation methodology. It is unlikely that there will be any clarity on this issue until the hearing before the Bundestag's Finance Committee in March 2021.
- Other amendments include supplementing the present-value over-collateralisation ratio with nominal over-collateralisation ratios, addressing administration costs, expanding cover pool reporting and stringent requirements for liquid cover pool assets.
- On balance, Pfandbriefe should exhibit higher quality standards than the EU minimum standard once the amendment is introduced in 2021. In addition, Pfandbriefe will continue to enjoy preferential treatment under supervisory law. For this reason, German Pfandbriefe qualify for the European designation as "European Covered Bond (Premium)". Aircraft Pfandbriefe are an exception to this, as they do not qualify for inclusion in the premium segment.
- The changes are viewed positively by rating agencies. However, due to the fact that Pfandbriefe already command strong credit ratings, we do not expect any upgrades; instead, their existing ratings should become more stable. Moreover, maturity extensions are likely to have a favourable impact on the over-collateralisation ratios that preserve their ratings.

Transposition not yet initiated in many countries

Timetable for EU harmonisation and progress on transposition by member states



Sources: EU, S&P, Helaba Research

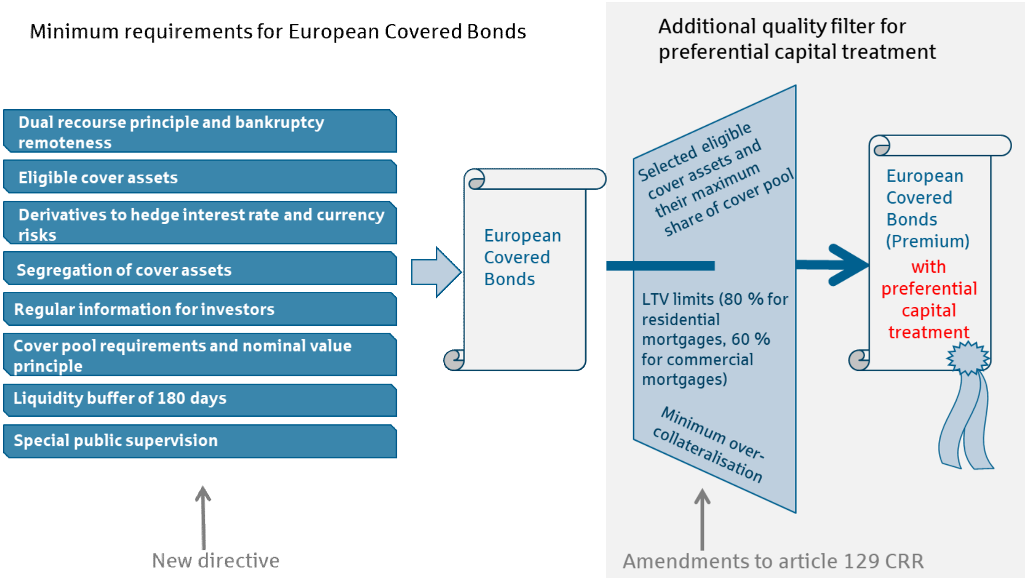
Inevitable that EU will postpone transposition deadline

The deadline for transposing the EU's legislative package into national law is approaching. On 8 July 2021, European minimum standards are scheduled to have been transposed into national covered bond laws. The new regulations must then be applied by all issuers from 8 July 2022 at the latest. Germany launched the process of adopting the necessary changes in the Pfandbrief Amendment Act 2021 (PfandBG-Novelle) at an early stage and is on track to meet the deadline.

However, the legal process for ratification in many countries has not got fully underway yet, which is presumably attributable to some extent to the Covid-19 crisis. It is extremely unlikely that every member state will be able to meet the deadline. Although we believe it is inevitable that the deadline will be postponed, the EU will probably insist that countries meet their obligation to transpose the legislation, especially in order not to jeopardise the application of preferential regulatory treatment.

Key structural and quality features of European covered bonds

Flow chart of covered bond harmonisation package, consisting of Covered Bond Directive and amendments to Article 129 CRR



Sources: EU Commission, Helaba Research

Long-term project on the home straight

The project to harmonise covered bond frameworks has been occupying the relevant European agencies for more than 6 years. The legislative package finally came into force in January 2020. In essence, lawmakers are striving to achieve the following goals:

1. The harmonisation of key structural features, better comparability and a simplification of the assessment process for investors in order to promote cross-border investments and support the expansion of nascent markets. Covered bonds fulfil a vital role as a source of finance, especially for the real estate market and, in future, perhaps (once again) for the public sector as well.
2. A precise definition of covered bonds as a benchmark for EU supervisory frameworks for the appropriate treatment of products from a risk perspective, e.g. in terms of liquidity and capital requirements. So far, in addition to the existing Article 129 CRR (Capital Requirement Regulation), there was only a short, incomplete definition contained within Article 52(4) of the UCITS Directive.

A precise definition of covered bonds by means of minimum standards

The EU legislative package for covered bonds lays down minimum standards based on principles and ensures qualitative criteria for covered bond frameworks in every EU country, which have so far varied greatly. The Covered Bond Directive replaces Article 52(4) of the UCITS Directive and describes key structural features of “**European Covered Bonds” (ECBs)**, stipulates minimum collateralisation and liquidity requirements, specifies disclosure requirements for investors and imposes special public supervision. In addition to the numerous mandatory provisions, the Directive also sets out a number of requirements for optional structural features, such as maturity extensions.

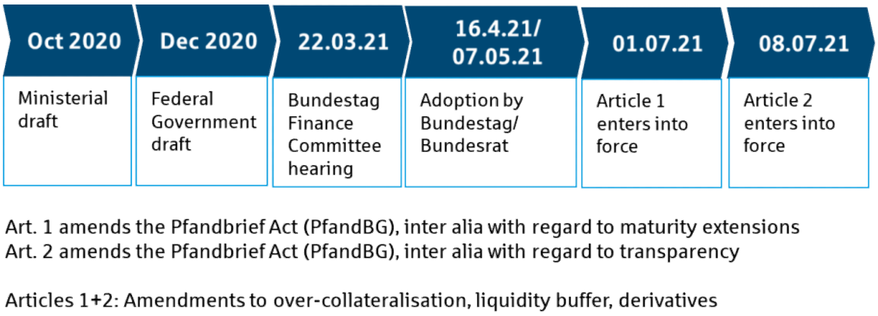
Adherence to strict quality criteria a prerequisite for preferential regulatory treatment

In order to continue to be granted preferential regulatory treatment, covered bonds will have to comply with both the mandatory provisions of the Covered Bond Directive and the stricter requirements of Article 129 CRR. The latter include, for example, a minimum over-collateralisation requirement as well as limits on receivables from credit institutions depending on the rating level. These covered bonds are eligible for the designation **"European Covered Bond (Premium)"**. Indeed, the criteria for premium ECBs replicate the stringent quality standards of some existing covered bonds such as German Pfandbriefe (except Aircraft Pfandbriefe).

German Pfandbrief Amendment Act: minor adjustments and a maturity extension on top

In our view, the changes being made to the Pfandbrief are modest in scope as we believe that the minimum European regulations have been largely inspired by the German Pfandbrief Act and its high standards. In addition, the most significant changes will not have any impact on day-to-day Pfandbrief operations. For example, apart from incorporating a handful of minor adjustments, the Pfandbrief Amendment Act primarily stands out by imposing a number of stricter requirements. Furthermore, by introducing a maturity extension, German lawmakers have opted for additional protection against liquidity risk in the event of a crisis. In this way, they are transposing one of the Covered Bond Directive's optional provisions.

Maturity extension enters into force on 1 July
Timetable of Pfandbrief Amendment Act until it enters into force



Sources: vdp, Helaba Research

The draft legislation contains various clarifications and adjustments in addition to the ratification of the EU regulations. For example, there are provisions that exempt receivables from UK sovereign borrowers that were included in cover pools before Brexit from the creditworthiness requirements now in force. Furthermore, it provides greater clarification of the more appropriate building insurance requirements and introduces electronic consent by trustees when cover assets are removed from the pool. Since cover assets also carry a negative deposit interest rate and are redeemed at a level lower than their nominal value, the law also clarifies that the redemption value must be used when calculating their recognition as a cover asset.

Higher quality than EU minimum standard ensures preferential treatment

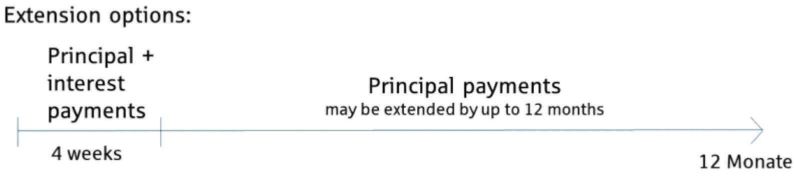
Overall, once the Pfandbrief Amendment Act 2021 has entered into force, Pfandbriefe should have a higher quality than the EU minimum standards and timely implementation is not the only reason why they will yet again live up to their reputation as a role model in the covered bond community. By aligning with the requirements of Article 129 CRR, lawmakers have ensured that Pfandbriefe will continue to enjoy preferential treatment with regard to supervisory law and EU regulations, such as the LCR Regulation. Therefore, Public Pfandbriefe, Mortgage Pfandbriefe and Ship Pfandbriefe will be covered by the label of European Covered Bond (Premium). An exception to this rule are Aircraft Pfandbriefe, which do not qualify for the premium segment.

Maturity extension: a last resort and not an automatic mechanism

Covered bonds with and without extendable maturities (often referred to as soft and hard bullet structures) are exactly the same as long as the issuing bank is solvent. In the worst-case scenario, however, extending the maturity of a bond is a tried-and-tested means of mitigating liquidity risk. An opportunity to buy some time to raise liquidity can help to prevent covered bonds from defaulting, especially in the case of pending high-volume maturities.

This could also benefit the cover pool administrator ("Sachwalter"), who is appointed to liquidate the cover assets and Pfandbrief liabilities in the event of the bank's insolvency. With the introduction of maturity extensions by the Pfandbrief Amendment Act, the cover pool administrator will in future have another instrument at his disposal to ensure sufficient liquidity is available to service Pfandbriefe in full and in a timely manner. This is also likely to be in the interest of investors.

New repayment structure applies to new and outstanding Pfandbriefe
Flowchart showing extension options



Sources: vdp, Helaba Research

Precise regulation of extension mechanisms

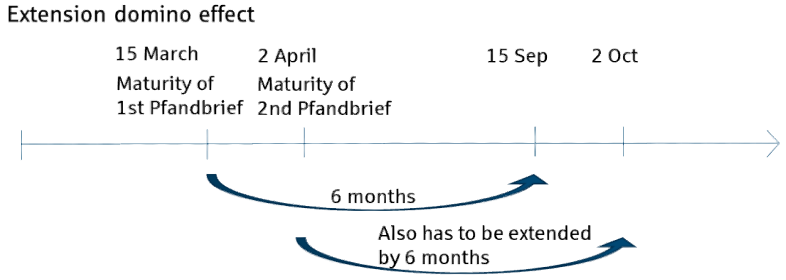
The new regulations allow the cover pool administrator to postpone principal and interest payments for the first four weeks after appointment at their own discretion and without the need for any specific conditions to be met. In total, s/he may extend maturity by a maximum of 12 months as required (several times, on a pro rata basis), if s/he considers that

- an extension is necessary to avoid insolvency (of the Pfandbriefbank with limited business activity, PfandBBk m.b.G), **and**
- the cover pool (PfandBBk m.b.G) is not over-indebted **and**
- it can be assumed that extension would result in solvency of the cover pool (PfandBBk m.b.G.).

Pursuant to the requirements of the Covered Bond Directive, the extension is subject to a so-called "time subordination" provision. This means that Pfandbriefe with later maturities may not be repaid before the extended bonds. Instead, an extension domino effect applies: if an extended Pfandbrief matures after another Pfandbrief as a result of the extension instead of on its original earlier date, repayment of the other Pfandbrief must also be extended.

Time subordination: maturity sequence may not be inverted

Flowchart of extension options



Sources: vdp, Helaba Research

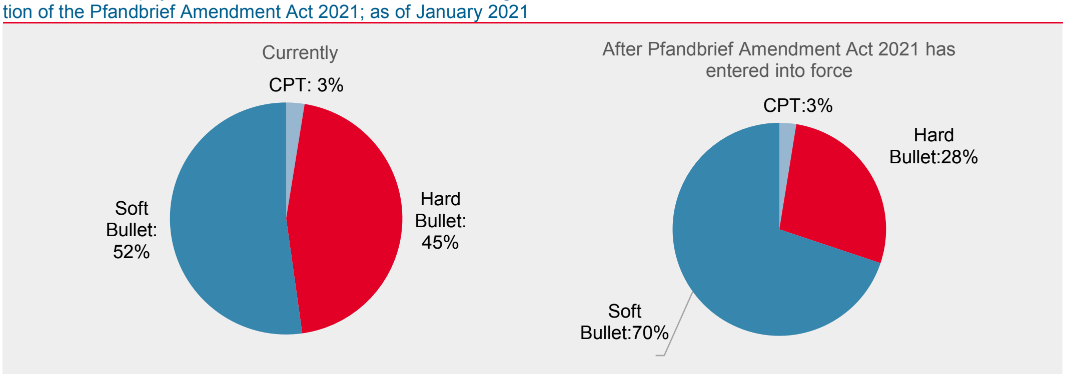
The cover pool administrator may also service the Pfandbriefe after they have been extended (ahead of schedule) which, however, leads to complex payment sequences. In any case, interest must be paid on the outstanding amount and the extension must be published. The law does not specify the type of interest payment. It is likely that the agreed conditions will continue to apply unless otherwise contractually defined. As of 8 July 2022, Pfandbrief issuers will be legally required to include information on the statutory option for cover pool administrators to extend the maturity in the bond terms and conditions.

Sharp rise in soft bullet covered bonds, but they remain fragmented

Covered bonds with extendable maturities have gained increasing international acceptance over the last few years and are now the dominant type of new issuance. Currently, their share of outstanding EUR benchmark covered bonds is around 52 %. However, most recently this share has barely risen as covered bonds from Germany and Spain, and especially some covered bond issuers from France, Sweden, Finland and Austria, have not yet introduced extendable maturities. As the Pfandbrief Amendment Act comes into force, the share of soft bullet covered bonds will increase significantly to 70 %. However, even though the nomenclature and structure of maturity extensions appear uniform, they are anything but. Despite EU minimum standards, differences in triggers, extension options and mechanisms, rules on interest payments and reporting mean that investors will still have their comparative work cut out for them. This only serves to highlight the benefits of the standardised rules in the German Pfandbrief Act that apply to all Pfandbriefe.

The Pfandbrief Amendment Act 2021 reinforces the instrument of extendable maturities

Breakdown of repayment structures based on the outstanding volumes of iBoxx EUR covered bonds before and after introduction of the Pfandbrief Amendment Act 2021; as of January 2021



Sources: Bloomberg, Helaba Research

At a glance: other key amendments to the Pfandbrief Act

Our assessment of the key changes contained within the German federal government's draft bill for the Pfandbrief Amendment Act is overwhelmingly positive.

- **Supplementing the present-value over-collateralisation ratios with nominal over-collateralisation ratios and addressing administration costs**: For the first time, the Pfandbrief Act will prescribe a minimum level of nominal over-collateralisation for Mortgage and Public Pfandbriefe of 2 % and for Ship and Aircraft Pfandbriefe of 5 % (from 2022). The existing minimum level of NPV over-collateralisation will remain, but administration costs will also be taken into account in the calculation (from 2021). A positive aspect is that this present-value over-collateralisation safeguard must be provided in the form of high-quality liquid cover assets (see also 'More stringent requirements for receivables from credit institutions' below) and that assets recognised as part of the present-value over-collateralisation safeguard may no longer be included in the nominal over-collateralisation cover.
- **More stringent requirements for receivables from credit institutions:** In future (from 2022), receivables from credit institutions from the same banking group will, as a rule, no longer qualify as cover assets (exception: deposits of up to 2 % resulting from payment transactions). This strict rule goes further than requirements imposed by the Covered Bond Directive. In addition, limits on receivables from credit institutions with a Level 1 rating (up to AA-) or Level 2 rating (up to A-) of a maximum of 15 % or of 10 % of outstanding Pfandbriefe, respectively, as defined in Article 129 CRR, shall apply. Receivables from credit institutions with a Level 3 rating (up to BBB-) are only permissible in respect of derivatives and are limited to a maximum of 8 %.
- **List of eligible derivative counterparties reduced:** In future (from 2021), only the German Federal Government, the federal states and suitable credit institutions (see above) will be recognised as derivative counterparties. It should be noted, however, that only a few Pfandbriefe have traditionally contained derivatives in their cover pools.
- **Expansion of cover pool reporting:** In line with the requirements of the Covered Bond Directive, from 2022 issuers will be obliged, in addition to current cover pool information (Article 28 PfandBG), to publish an ISIN list for bearer covered bonds, a breakdown of the over-collateralisation according to statutory, contractual and voluntary shares, conditions for maturity extensions, the volume-weighted average of elapsed mortgage loan terms as well as liquidity risk indicators. The requirement of **three indicators for liquidity risk** (the largest liquidity shortfall over the next 180 days; the day on which the liquidity shortfall occurs; the total amount of all liquid cover assets) means that national (German) regulations will significantly exceed EU requirements.
- **Liquidity buffer: strong protection for investors:** The fact that the German government's draft bill retains the 180-day liquidity rule in its current quality despite also introducing extendable maturities as an additional instrument to protect against liquidity risks and that German issuers would have preferred to see the liquidity buffer reduced, means that investors will benefit from a double safeguard and a strong level of protection. For instance, the Pfandbriefbank will still be required to provide sufficient liquid funds (liquidity buffer) to cover the largest negative liquidity shortfall over the next 180 days. In addition, the recoverable assets used for the liquidity buffer will be upgraded by the Pfandbrief Amendment Act since, as well as being aligned with the eligible assets of the LCR Regulation, they now only comprise deposits at credit institutions with Level 1 and 2 ratings (although the Directive permits short-term deposits at credit institutions with Level 3 ratings).

Relief in sight for overlap between Pfandbrief Act and LCR Regulation

The alignment of eligible assets to those defined in the LCR Regulation also addresses a key issue for banks - they will **no longer have to maintain two separate liquidity buffers** for the first 30 days, one pursuant to the Pfandbrief Act and another to the Liquidity Regulation. Currently, there is an overlap between the two laws for this period (because the LCR Regulation does not recognise liquid cover assets as "encumbered" assets due to their separability from the insolvency estate).

However, an amendment to the LCR Regulation is still required to alleviate this twin burden for banks. The EU Commission has already prepared a draft amendment that will make the new regulations legally binding as soon as the Covered Bond Directive enters into force on 8 July 2022.

Changes proposed by Association of German Pfandbrief Banks (vdp) would weaken liquidity buffer

There is still a chance that the liquidity buffer could be watered down, because issuers' associations under the auspices of the Association of German Pfandbrief Banks (vdp) are pushing for two changes in the calculation of the 180-day liquidity requirement. Firstly, they want the calculation of **incoming payments** to be based on the end of the fixed-interest period and not on the expected repayment date of the cover assets. While other covered bond frameworks also use this approach and it would not be unique to Pfandbriefe, it could theoretically lead to a situation in which incoming payments appear to be early and reduce liquidity shortfalls. What is more, it is impossible to predict whether the cover pool administrator will actually be able to secure repayment of the loans at the end of the fixed-interest period by imposing high follow-up terms and whether worst-case scenario assumptions are realistic. Secondly, the association wants to make use of an option in the Covered Bond Directive that provides for taking maturity extensions on Pfandbriefe into account when calculating **outgoing payments**. This would also significantly reduce potential liquidity shortfalls. As a result of both amendments, the amount of the liquidity buffer would essentially only be determined by shortfalls resulting from different incoming and outgoing interest payments and would therefore be considerably weakened. Whether the associations' amendments will be accepted by German lawmakers should be known in March at the earliest after a hearing by the Bundestag's Finance Committee.

No impact on ratings expected

Rating agencies have responded favourably to the proposed legislation and, as we understand it, have not given any indication that it could lead to rating downgrades. In fact, the opposite is true: extendable maturities should generally improve maturity mismatches and have a positive effect on over-collateralisation ratios that preserve ratings, especially in the case of Pfandbriefe secured by residential mortgages. Fitch even sees a chance that the maximum possible gap between the issuer and Pfandbrief rating, the rating buffer (known as the Payment Continuity Uplift, or PCU, at Fitch), which also has an impact on the Pfandbrief rating according to the agency's standards, could increase as a result of the introduction of maturity extensions. Currently, the rating buffer at Fitch is 4 notches for Mortgage Pfandbriefe and 5 notches for Public Pfandbriefe. Since German Pfandbriefe already enjoy very strong ratings, we do not expect much in the way of rating upgrades. However, higher rating buffers contribute to improved rating stability.

From an economic standpoint, we can certainly appreciate why German policymakers may still decide to weaken the liquidity buffer. Holding large quantities of highly liquid assets has become expensive for issuers given the negative interest rate environment that has persisted for the last few years (especially if two liquidity coverage ratios have to be met). That is why maturity extensions have been a welcome alternative for many covered bond issuers in recent years. Nevertheless, this decision would prevent the establishment of a genuinely strong protection regime that would enable the Pfandbrief to stand out even more clearly from other covered bonds. Rating agencies often reward the existence of extendable maturities in their rating assessments in a similarly positive way as the 180-day liquidity rule. We do not expect a negative impact on Pfandbrief ratings as a result of a weaker liquidity buffer and the simultaneous introduction of extendable maturities, as long as interest payments on Pfandbriefe continue to be covered.

Overview of legislation and additions/amendments

	Pfandbrief Act	Pfandbrief Amendment Act 2021
Designation	Pfandbriefe	Pfandbriefe (European Covered Bond, European Covered Bond (Premium))
Issuer	Universal banks with a special licence. Authorisation is granted by the supervisory authority BaFin.	
Cover pool owner	Direct issuer	
What happens in the event of insolvency of the issuer?	Claims continued to be serviced	
Protection from claims by other creditors	Preferential claim by law, special cover pool administration	
Right of recourse to the bank's insolvency estate if the cover pool becomes insolvent	Yes, pari passu with unsecured creditors	
Eligible cover assets	Mortgage loans, public-sector receivables, ship or aircraft loans - depending on the type of Pfandbrief	
Additional eligible cover assets	Receivables from ECB, central banks and other credit institutions (up to 10 %), derivatives*; additionally, for Mortgage, Ship and Aircraft Pfandbriefe: Receivables from public-sector entities (Up to 20 % for Mortgage Pfandbriefe less the above-mentioned receivables; up to 10 % for Public Pfandbriefe) *net present value of derivatives: max. 12 %	Receivables from ECB, central banks and other credit institutions (**up to 15 %** - CIs with Level 3 ratings only as derivatives counterparties), derivatives*; additionally, for Mortgage, Ship and Aircraft Pfandbriefe: Receivables from public-sector entities (Up to 20 % for Mortgage Pfandbriefe less the above-mentioned receivables; **up to 15 %** for Public Pfandbriefe *net present value of derivatives: max. 12 %; derivatives must be netted against the above limits
Geographical restrictions	Mortgage Pfandbriefe: EEA, UK, Australia, Japan, Canada, New Zealand, Switzerland, Singapore, USA°. Public Pfandbriefe: EEA, UK, Switzerland, USA, Canada, Japan Ship and Aircraft Pfandbriefe: worldwide	
LTV limits	Residential mortgage loans: 60 % Commercial mortgage loans: 60 % Shipping loans: 60 % Aircraft loans: 60 %	
Calculation of OC	Lending value of property	
Loan portion above LTV limit	Not available for covered bondholders	
Minimum over-collateralisation	Net present value: 2 % (within scope of stress test)	Net present value: 2 % (NPV over-collateralisation safeguard within scope of stress test, covers administration costs); **Nominal:** Mortgage and Public Pfandbriefe: **2 %** Aircraft and Ship Pfandbriefe: **5 %**
Voluntary over-collateralisation (above the statutory minimum over-collateralisation)	Protected, available to covered bondholders	

Limit on outstanding volume of covered bonds	No	
Protection against market risks	Stress tests for cover calculation, derivatives allowed	
Protection against liquidity risks	Maintenance of 180-day liquidity buffer	Maintenance of 180-day liquidity buffer: - Proposed change: based on the fixed interest rate of the cover assets, not on the capital commitment - Proposed change: consideration of a maturity extension
Special repayment mechanisms after bank default	No	**Maturity extension** of up to 12 months as last resort by cover pool administrator
Special public supervision	Federal Financial Supervisory Authority (BaFin)	
Independent audit of the cover pool	Yes, by trustee	
Special administrator after bank default	Yes, cover pool administrator	

°share of countries outside the EU in which preferential treatment of covered bondholders is not guaranteed in case of bankruptcy: max. 10%

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