

Should a harmonized framework dedicated to covered bonds and cover pools in bank resolution procedures be created?

Moderator

Mr. Kristian Ingemann Petersen

Panelists

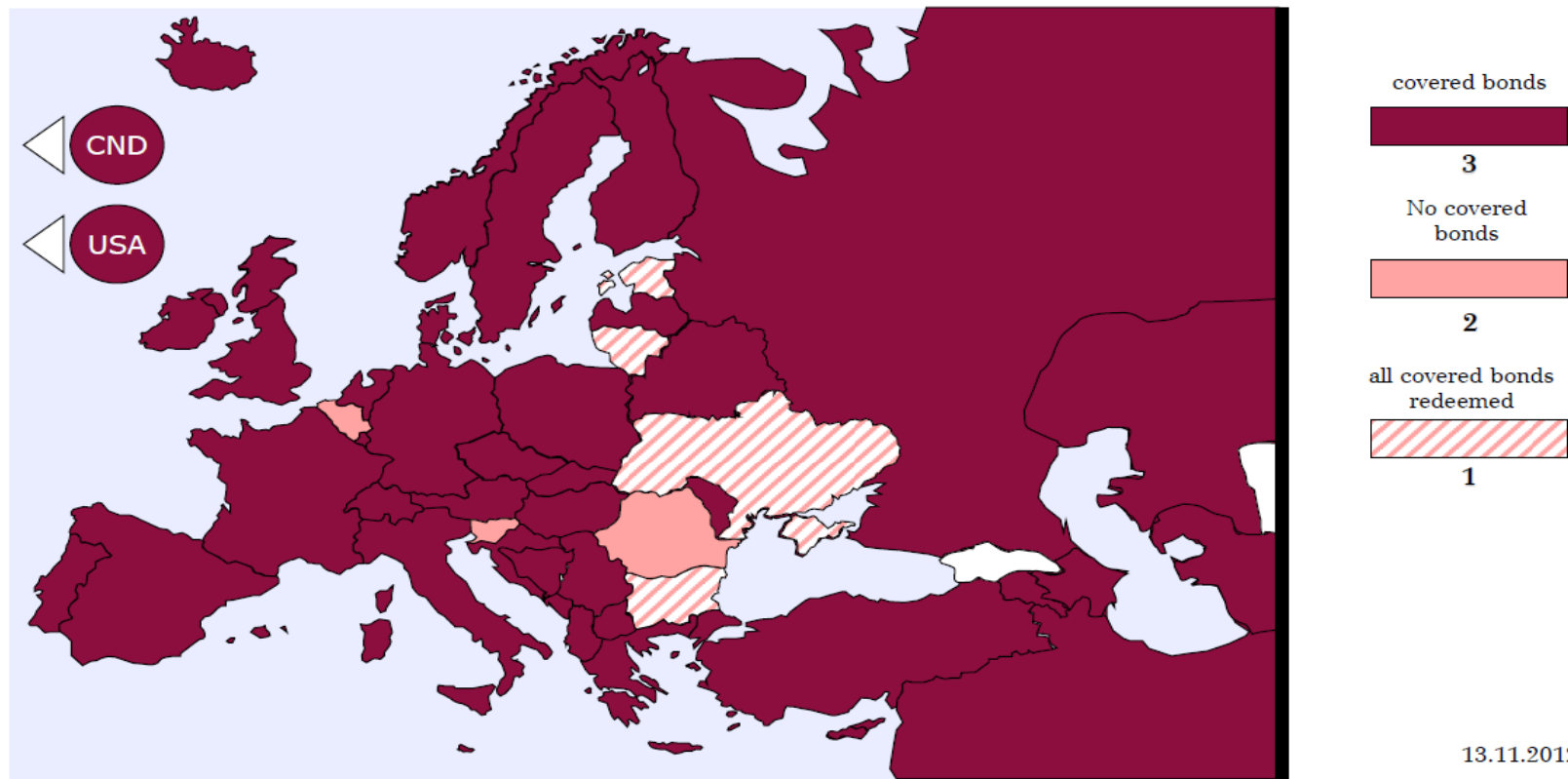
Mr. Kai Spitzer

Mr. Martin Bourbeck

Mr. Clément Royo

Mr. Filipe Santos Barata

Countries with covered bonds

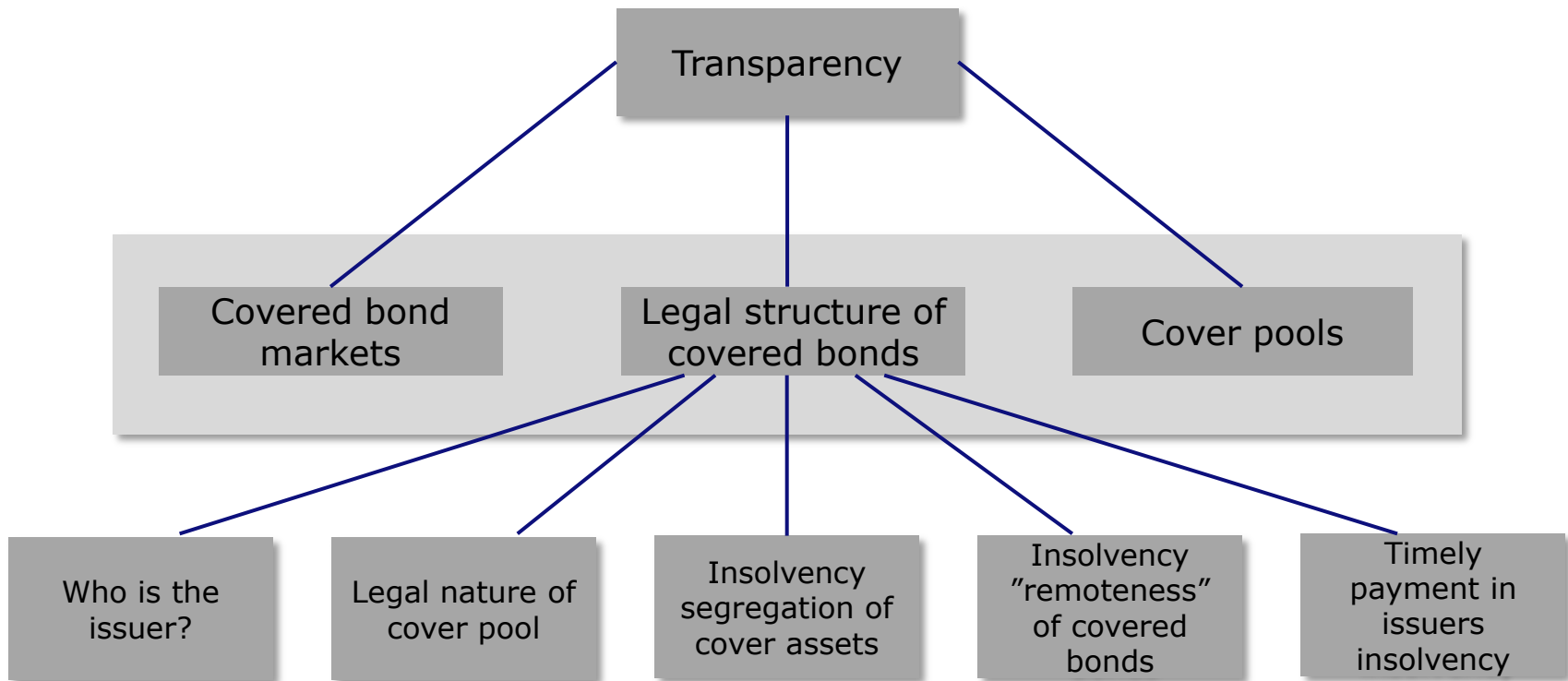


Source: vdp, Berlin

Background

- In the EU, the regulation of covered bonds is a matter left to member states national laws. From the EBA report from last year we know that 26 countries have implemented a dedicated covered bond legislation
- National laws set out requirements on a variety of subject matters such as:
 - a) Authorisation of credit institutions as covered bond issuers – license to issue covered bonds
 - b) Special public supervision of the issuer and the cover pool
 - c) Types of eligible cover assets
 - d) Segregation of the cover pool upon insolvency of the issuer
 - e) Standards of disclosure to investors
 - f) Derivatives in cover pool
- Several models are used for issuing covered bonds in Europe

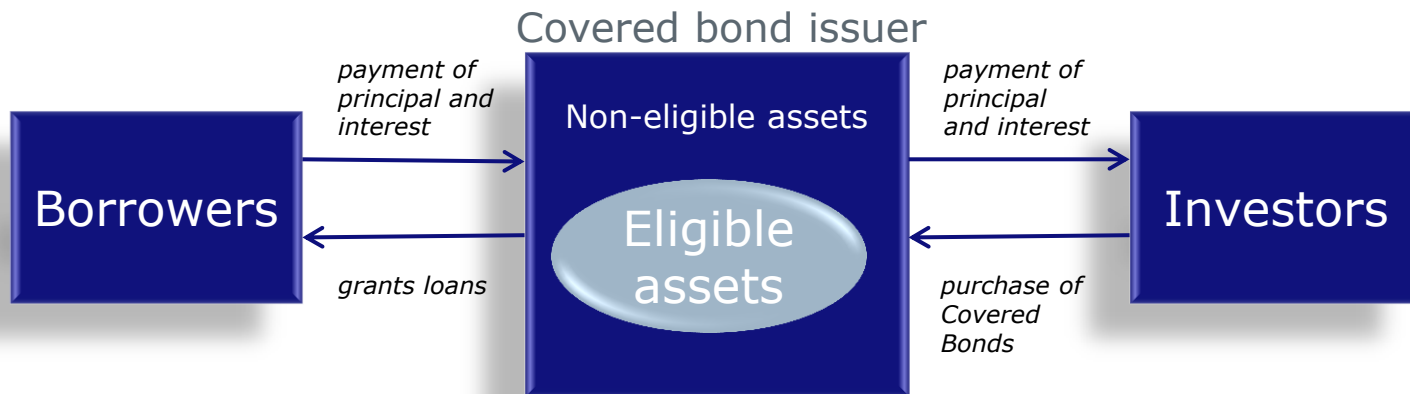
Transparency of legal structure of covered bonds



Specialised credit institution models

Covered bond issuer is a specialized credit institution by law:

Denmark, Hungary, Luxemburg, Norway, Poland



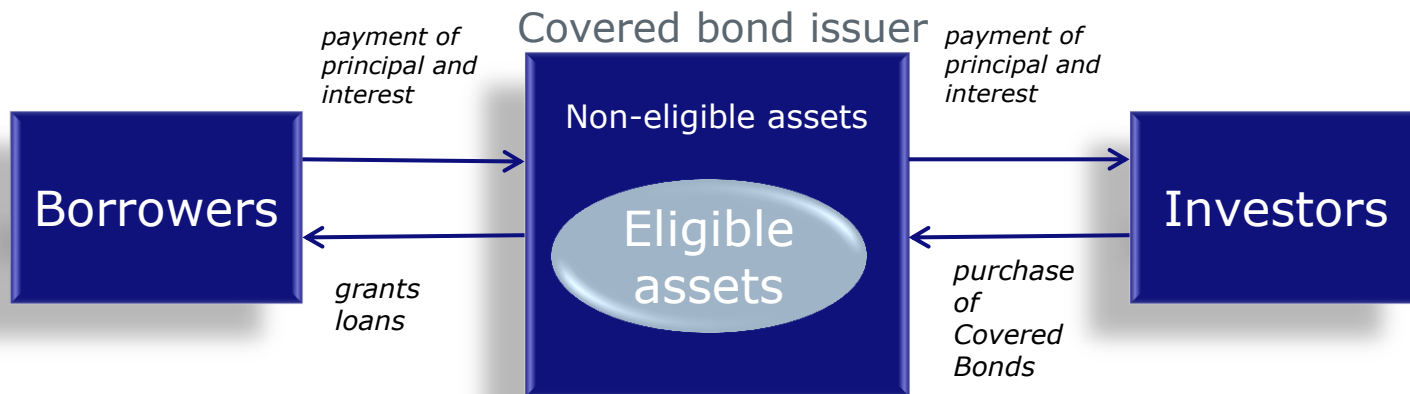
- Issuer originates, services and funds eligible and non-eligible business
- Loan origination restricted by law to mortgages and public-sector loans
- Issuer has the legal status of a credit institution
- Key challenge: insolvency segregation of cover assets from insolvency estate

Source: Roundtable covered bonds and VDP, Berlin

Universal credit institution models

Covered bond issuer is a universal credit institution by law:

Austria, Belgium, Bulgaria, Czech Republic, Cyprus, Finland, Germany, Greece, Iceland, Latvia, Lithuania, Portugal, Romania, Russia, Slovakia, Slovenia, Spain, Sweden



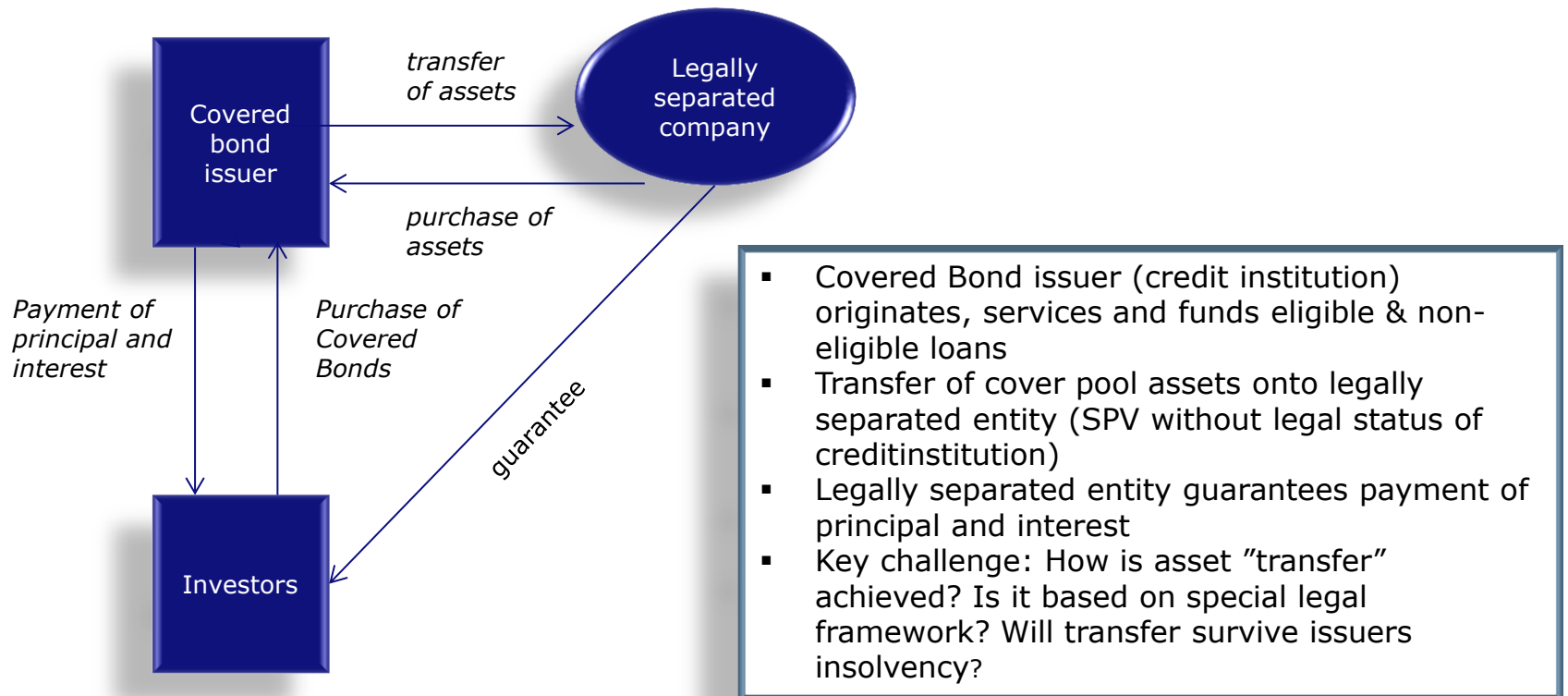
- Issuer originates, services and funds eligible and non-eligible business
- Strict eligibility criteria apply to eligible cover assets
- Issuance governed by special legal framework
- Key challenge: insolvency segregation of cover assets from insolvency estate

Source; Roundtable covered bonds and VDP Berlin

SPV models

Covered bond issuer uses SPV to achieve insolvency segregation of cover assets:

Italy, Netherlands, UK



Source Roundtable covered bonds and VDP

Background

EU regulation does not regulate covered bonds directly, but lay down prudential treatment in various legislations

- UCITS directive - Article 52 (4)
- CRR article 129 – minimum requirements in relation to the cover assets and levels of transparency to investors that covered bonds referred to in UCITS must meet.
- Solvency II Delegated Act
- LCR Delegated Act

Do we need a precise definition of covered bonds before we can harmonize the Resolution Framework?

BRRD

1. Purposes of the Recovery and Resolution Directive

- Providing common European framework for early intervention and resolution powers to address systemic risk

2. Scope

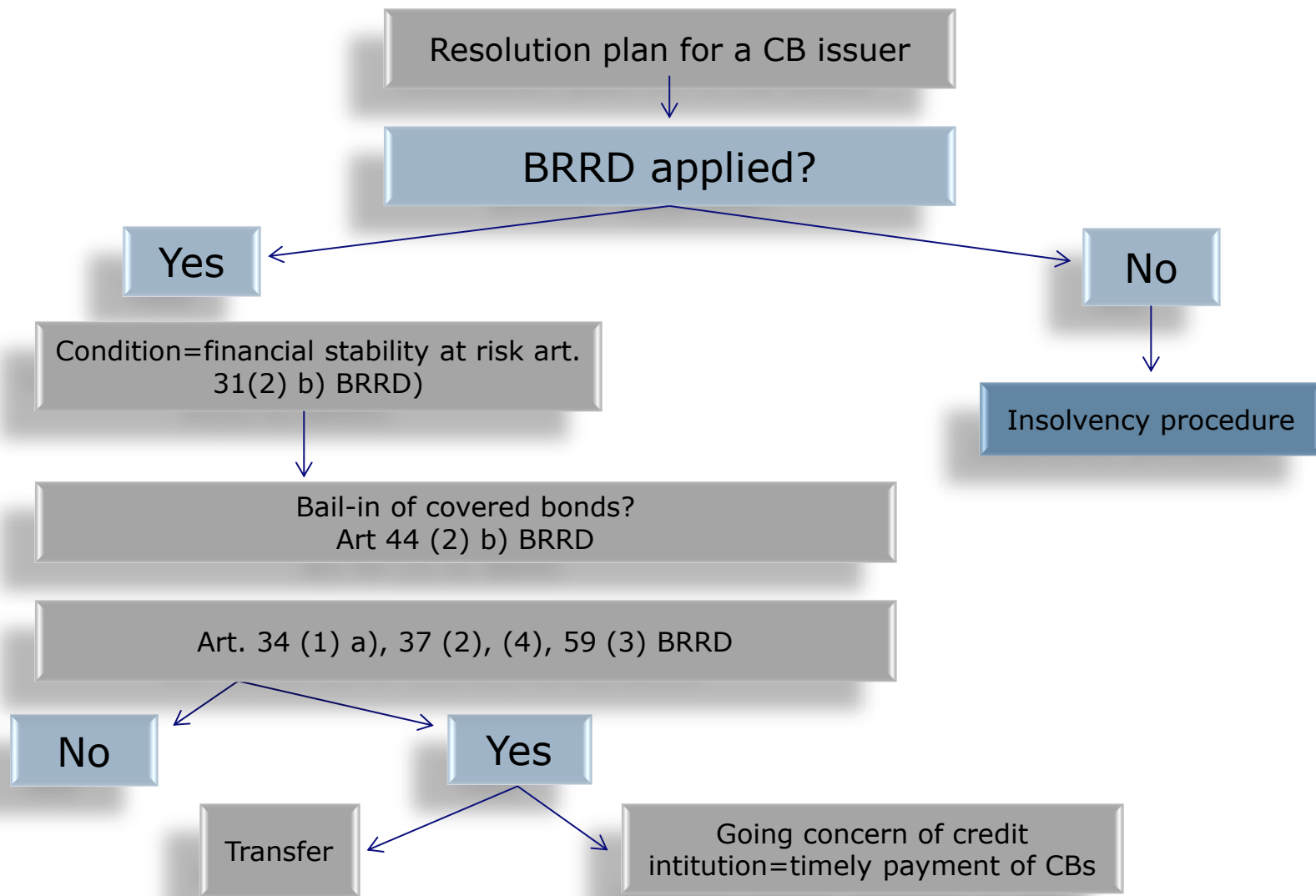
- All credit institutions and investment firms (institutions) established in the EU
- Branches of third-country institutions
- The definition of covered bonds in BRRD is the UCITS definition

BRRD

3. General principles for resolution

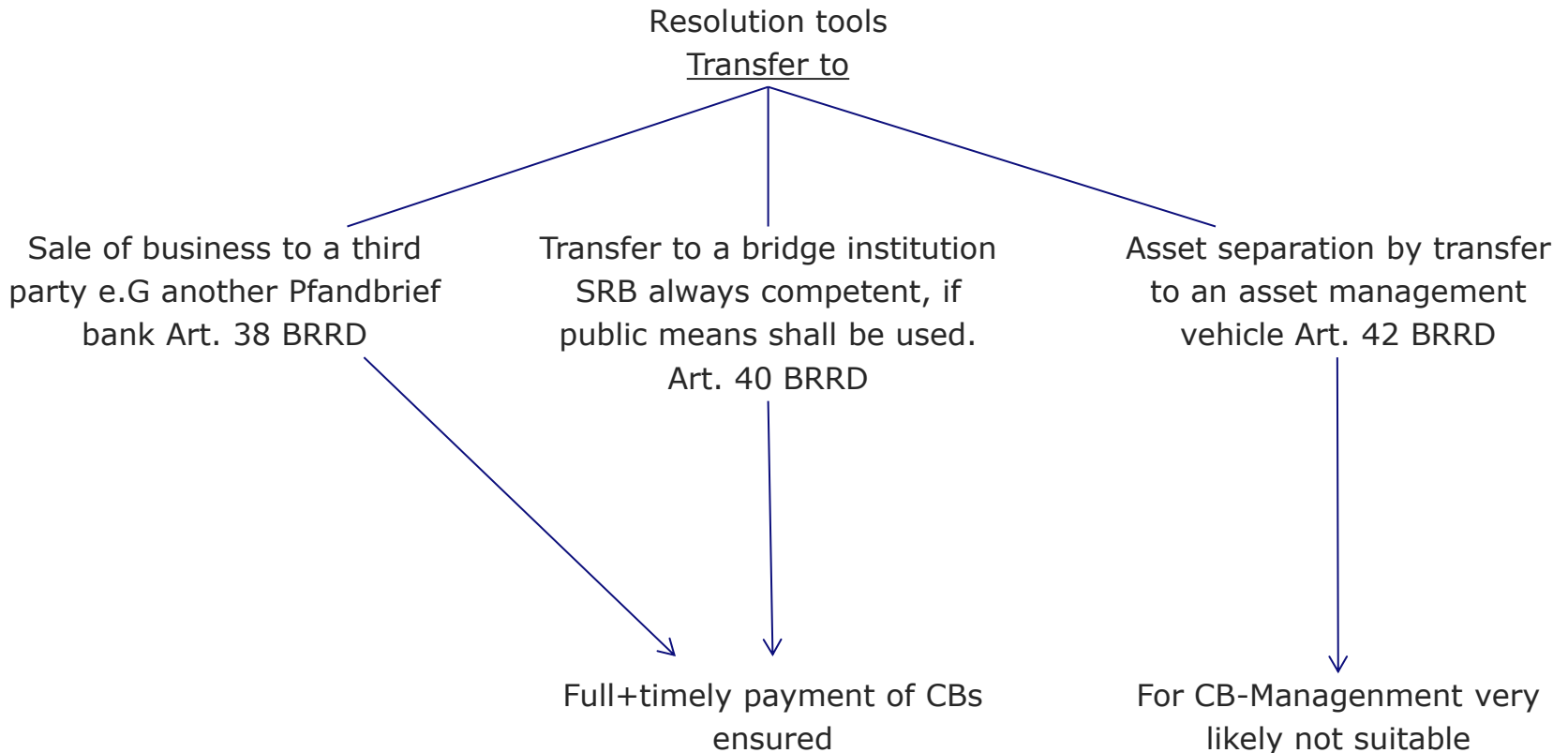
- Shareholders shall bear first losses
- Creditors bear losses after shareholders in a prescribed waterfall, in principle, equal treatment of all creditors of the same class
- No creditor incurs greater losses than in normal insolvency
- *“BRRD excludes covered bonds from the scope of the bail-in tool and mandates Member states to ensure that all secured assets relating to a covered bond cover pool remain unaffected, segregated and with enough funding in the event that resolution authorities exercise write-down or conversion powers in relation to the liabilities of a credit institution”*

Source Consultation document covered bonds in the European Union



BRRD

Bail-in of CBs only, if CBs exceed cover assets
Art. 44 (2) sup.par. 3 BRRD



BRRD Implementation in Germany

Focusing on covered bonds

Presented to the 19. Central European Covered Bond Conference,
Campus Catalunya (Rovira i Virgili University), Tarragona

BRRD implementation in Germany

focusing on covered bonds



1. Sec. 36a Pfandbrief Act (a primer)
2. BRRD Transposition Act of 10 December 2014 (BRRD-Umsetzungsgesetz / BRRD-UmsG, Federal Law Gazette I, p. 2091)
 - a) Establishment of Act on Restructuring and Resolution of Institutions and Financial Groups (Sanierungs- und Abwicklungsgesetz / SAG) [Article 1]
 - b) Amendment to sec. 36a Pfandbrief Act [Article 4]
3. Bill on Resolution Mechanism (Abwicklungsmechanismengesetz / AbwMechG, Bundestag approved on 24 September 2015, due to pass Bundesrat on 16 October 2015, latest version Bundesratsdrs. 419/15)
 - a) Amendment to SAG [Article 1]
 - b) Amendment to sec. 36a Pfandbrief Act [Article 5]

BRRD implementation in Germany

1. sec. 36a Pfandbrief Act (a primer)

Sec. 36a Pfandbrief Act

- in general gives prevalence to Pfandbrief investor protection mechanism (established for issuer insolvency) in cases of (forced) restructuring or resolution
- in general requires restructuring measures with direct impact on Pfandbrief business to be implemented by cover pool administrator (rather than to take direct effect)
- provides for possibility to re-establish effect of immediate legal transfer in respective transfer order ...
- ... but in case of non-EEA cover assets affected, only upon appointment of cover pool administrator as trustee for transferee

rationale:

- trust agreements according to national law of non-EEA cover assets for the benefit of Pfandbrief creditors typically require cover pool administrator as agent for beneficiary in involuntary transfers;
- geographical carve-out based on obligation to implement Article 3 par. 2 of Directive 2001/24/EC; BRRD-changes to definition of "reorganization measures" deemed immaterial in nature, thus pending introduction of BRRD into EEA Treaty irrelevant

BRRD implementation in Germany

2. a) Restructuring and Resolution Act (SAG)



The Restructuring and Resolution Act (SAG, Article 1 BRRD-UmsG), in force per 1 January 2015, inter alia establishes:

- Federal Agency for Financial Market Stabilisation (FMSA) as resolution authority, sec. 3 par. 1 SAG (FMSA to be integrated with semi-legal status into BaFin)
- NCWO by inter alia no extension of bail-in effect for the benefit of guarantors, sec. 99 par. 8 SAG (mirroring respective rules in insolvency law, cf. sec. 254 par. 2, sec. 301 par. 2 InsO) [→ NCWO principle established in Article 32 par. 1 lit. g BRRD, Article 15 par. 1 lit. g SRMR]
- definition of covered bonds along compliance with Article 52 (4) UCITS Directive, sec. 2 par. 3 no. 24 SAG [→ Article 2 par. 1 no. 96 BRRD, Article 3 par. 1 no. 52 SRMR]
- exemption from broad power to modify terms of transactions, sec. 79 par. 6 SAG [→ Article 63 par. 1 lit. g, j, Article 79 par. 1 lit. b BRRD, implicitly for NRA acting: Article 29 par. 1 sub-par. 3 icw Article 18 par. 9, Article 23 sub-par. 1, Article 15 par. 1 lit. i (but: "safeguards in this Regulation": ∅) SRMR, **for Board acting in emergency acc. to Article 29 par. 2 SRMR: ???**]
- bail-in exemption for covered bonds (and cover pool derivatives) to the extent the cover is of value, sec. 91 par. 2 no. 2 SAG [→ Article 44 par 2 lit. b, sub-par. 3 BRRD, Article 27 par. 3 lit. b, par. 4 SRMR]

BRRD implementation in Germany

2. a) SAG (cont'd) & 2. b) Pfandbrief Act

SAG (cont'd):

- MREL to be set individually by FMSA, after consultation of NCA, based on general criteria in sec. 49 *et seq.* SAG [→ Article 45 BRRD; Article 12 SRMR]
- covered bond liabilities, to the extent the cover is of value, do not qualify as (MR)EL, sec. 49 par. 2 no. 2 SAG [→ Article 45 par. 4 lit. b BRRD; Article 12 par. 16 lit. b SRMR]
- ban on separation of assets entered into cover register and corresponding liabilities from circulating covered bonds for transfer tool, sec. 110 par. 3 no. 5 SAG [→ Article 76 par. 2 lit. e, Article 79 par. 1 BRRD, implicitly for NRA acting: Article 29 par. 1 sub-par. 3 icw Article 18 par. 9, Article 23 sub-par. 1, Article 15 par. 1 lit. i (but: "safeguards in this Regulation": Ø) SRMR, **for Board acting in emergency acc. to Article 29 par. 2 SRMR: ???**]

Amendment of sec. 36a par. 2 Pfandbrief Act [Article 4 no. 13 BRRD-UmsG]

- no immediate effect of transfer of Pfandbrief business, but transfer to be effected in accordance with mechanism established for insolvency of Pfandbrief bank / issuer (cover pool administrator)
- continuation of possibility to specifically provide for immediately effective transfer, subject to establishment of cover pool administrator in case of non-EEA cover assets

BRRD implementation in Germany

3. a) SAG amendment & 3. b) Pfandbrief Act

Amendment to sec. 113 par. 1 SAG, mirroring “legal halt” clause for transfer of Pfandbrief business of sec. 36a par. 2 Pfandbrief Act into SAG [Article 1 no. 30 AbwMechG-E]

Amendment of Pfandbrief Act (BRRD/SRM context) in sec. 36a Pfandbrief Act [Article 5 no. 5 AbwMechG-E]

- Competence *of resolution authority* (not BaFin as special public supervisor) to establish cover pool administrator in case of transfer of non-EEA cover assets
- Rules provided for in case of transfer tool also to apply in case of transfer of Pfandbrief business in accordance with Articles 24 to 26 of SRM-Regulation

Danish implementation of BRRD for specialised mortgage banks

- ***The bail in tool does not apply to Danish mortgage banks***

This means:

- Covered bonds and sec. 15 bonds (senior secured bonds) are untouched
- Senior unsecured debt is formally untouched. However, it is possible to abandon the senior unsecured debt in distressed banks
- Capital instruments may be written down.

- **No MREL requirement for mortgage banks. Instead debt buffer** (FBA section 125 i)

- A Danish debt buffer requirement of 2% of outstanding mortgage loans (unweighted)
- The debt buffer to be phased fully in by 2020

BES/NOVO BANCO: resolution measures

19th CENTRAL EUROPEAN COVERED BOND CONFERENCE

Tarragona, 22 October 2015

Filipe Santos Barata

GÓMEZ-ACEBO & POMBO

- I. CREDIT INSTITUTION UNDER DISTRESS:
FORMS OF INTERVENTION**

- II. REASONS FOR THE APPLICATION OF THE RESOLUTION MEASURE
TO BANCO ESPÍRITO SANTO, S.A. (“BES”)**

- III. WAS IT THE BEST SOLUTION?**

- IV. THE BRIDGE BANK: NOVO BANCO**

- V. NEXT STEPS**

I. CREDIT INSTITUTION UNDER DISTRESS: FORMS OF INTERVENTION

- a) Recapitalisation with recourse to public funding;**
- b) Nationalisation;**
- c) Judicial liquidation;**

I. CREDIT INSTITUTION UNDER DISTRESS: FORMS OF INTERVENTION

d) Application of a resolution measure

Special procedure to be applied in order to achieve the resolution objectives which are of a public interest nature and consist in avoiding adverse effects on financial stability, preserving the continuity of critical banking functions, ensuring depositor's protection and safeguarding public funds, minimizing reliance on extraordinary public financial support.

I. CREDIT INSTITUTION UNDER DISTRESS: FORMS OF INTERVENTION

Although the application of resolution measures does not necessarily imply the prior adoption of corrective intervention measures, they are reserved for extreme situations, when both corrective measures and provisory administration measures are no longer viable and when:

- (1) the credit institution does not meet or is in serious risk of not meeting the requirements to maintain the authorisation to carry on its business;
- (2) it is not foreseeable that such credit institution can, within a reasonable time frame, perform the necessary measures to return to financial soundness and comply with prudential ratios; or

I. CREDIT INSTITUTION UNDER DISTRESS: FORMS OF INTERVENTION

(3) such measures are necessary to:

- avoid systemic risks in the banking sector (*follow-on wave of failure of other financial firms*);
- avoid potential negative impacts in the financial stability plan;
- minimise the costs in the public purse; or
- safeguard the confidence of depositors.

I. CREDIT INSTITUTION UNDER DISTRESS: FORMS OF INTERVENTION

By the time the resolution measure was adopted there were 2 types of resolution measures available:

- (1) (Total or partial) sale of the business to another credit institution authorised to carry on the activity in question;
- (2) Setting-up of one or more bridge bank(s) and (total or partial) transfer of the business of the distressed institution to the new bank(s).

I. CREDIT INSTITUTION UNDER DISTRESS: FORMS OF INTERVENTION

Before the resolution of BES on 3 August 2014:

- the principles of shareholders and subordinated creditors bearing losses first and the last resort nature of resolution tools were already in place; and
- the possibility of transferring part or all of the activity and assets, liabilities, off-balance sheet items and assets under management to another credit institution *or* a bridge bank were already hard law.

I. CREDIT INSTITUTION UNDER DISTRESS: FORMS OF INTERVENTION

In 2015, the key resolution tools now available are:

- a) SALE OF BUSINESS: *selling the bank or parts of the bank;*
- b) BRIDGE INSTITUTION: *setting up a bridge institution;*
PLUS
- c) ASSET SEPARATION: *separating good assets from bad ones;*
- d) BAIL-IN: *bailing in shares (write down) and debt instruments (creditor claims are reduced or converted into equity)*

II. REASONS FOR THE APPLICATION OF THE RESOLUTION MEASURE TO BES

On 3 August 2014, the Bank of Portugal (BoP) imposed on BES in the face of BES imminent risk of default and in order to preserve the stability of the entire Portuguese Banking system the resolution measure consisting in the *transfer of most of its business (assets, liabilities, off-balance-sheet items and assets under management) to a newly created bridge bank (“banco de transição”), Novo Banco, S.A. (“Novo Banco”), specifically set up for this purpose, which is envisaged to be sold at a later stage.*

II. REASONS FOR THE APPLICATION OF THE RESOLUTION MEASURE TO BES

BoP announced that the general activity and assets of BES are transferred, immediately and definitively, to Novo Banco, which is duly capitalised and clean of problem assets.

Deposits are fully preserved, as well as all unsubordinated bonds.

BES was a major Portuguese bank and part of one of the biggest economic groups in Portugal, holding interest across several sectors.

II. REASONS FOR THE APPLICATION OF THE RESOLUTION MEASURE TO BES

BES was at the heart of a complex web of family-owned companies with investments that stretched from mining projects in Angola to hotels in Portugal.

This measure was applied after the very high and unexpected losses in its results for the first half of 2014 and, inter alia, the decision of the ECB to suspend its counterparty status.

BES had reported a EUR 3.6bn loss, taking Common Equity Tier 1 levels to 5%, below the minimum regulatory level.

II. REASONS FOR THE APPLICATION OF THE RESOLUTION MEASURE TO BES

BES collapsed amid a record first-half loss triggered by its exposure to its troubled family-controlled parent company

Depositors and senior debt holders were protected by the BoP (resolution authority) as they were transferred to Novo Banco; shareholder and holders of BES junior debt instruments were not transferred to Novo Banco.

Besides their investment in the shares of BES, qualified shareholders' credits over BES were retained at the 'bad bank'.

II. REASONS FOR THE APPLICATION OF THE RESOLUTION MEASURE TO BES

As for Covered Bonds, as Senior Secured debt instruments, the relevant issues were transferred to Novo Banco:

- BES HIPOTEC.SER.6 PTBENAOE0014 BES Senior Debt / Obrigações hipotecárias
- BES– Obrigações Hipotecárias – Série 4 PTBER9OE0012 BES Senior Debt / Obrigações hipotecárias
- BES – Obrigações Hipotecárias – Série 7 PTBEQAOE0011 BES Senior Debt / Obrigações hipotecárias
- BES– Obrigações Hipotecárias PTBLMVOE0011 BES Senior Debt /Obrigações hipotecárias
- BES– Obrigações Hipotecárias – Série 5 PTBLMIOE0018 BES Senior Debt / Obrigações hipotecárias

III. WAS IT THE BEST SOLUTION?

- Recovery and Resolution Plans are commercially highly sensitive, unpredictable and highly political;
- This was the first application of the resolution regime under Portuguese banking law;
- The resolution scheme adopted by Bank of Portugal for BES helped stabilise the system while (apparently) limiting the taxpayer contribution needed to support the bank;

III. WAS IT THE BEST SOLUTION?

- The negative developments at BES and uncertainties around the magnitude of the losses that the bank was facing had some short-term market implications for Portugal's largest banks, which faced substantial volatility in their stock prices and credit spreads;
- The failure of BES demonstrated the vulnerability of the system to any event that could negatively affect investor's perception of the creditworthiness of Portuguese banks;

III. WAS IT THE BEST SOLUTION?

- Resolution of a systemically important financial firm constitutes a credible alternative to bail-out or some other sort of taxpayer assistance;
- It would have been desirable that an initial valuation at the entry into resolution determine once and for all the allocation of losses between shareholders and the different class of creditors but it was unrealisable;
- The intervention by the BoP and subsequent protection of depositors and senior creditors quickly calmed the market.

IV. THE BRIDGE BANK: NOVO BANCO

NOVO BANCO is subject to the legal and regulatory framework applicable to Portuguese banks.

Novo Banco's equity capital in the amount of €4.9 billion is held in full by the Resolution Fund, which is its sole shareholder;

The Resolution Fund depends upon contributions by the Portuguese banking system, and which will need to ultimately reimburse the Portuguese State of the loan it advanced to the Resolution Fund and was used to pay most of the share capital of Novo Banco.

IV. THE BRIDGE BANK: NOVO BANCO

If the sale of Novo Banco fails to be accomplished in a fashionable manner, Portuguese banks could face losses on the portion of their contributions to the Resolution Fund.

The state loan to the Resolution Fund will be paid back from the proceeds of Novo Banco's sale. If the price tag is below €4.9 billion, banks, not taxpayers, in theory fall liable for the difference.

IV. THE BRIDGE BANK: NOVO BANCO

This summer, the Portuguese central bank made a short list of three bidders for Novo Banco (the Anbang Insurance Group, had made the highest offer, followed by Apollo Global Management. Fosun International, another Chinese insurance and asset management company, was reported to have been third)

The continued difficulties of Novo Banco, linked to the investments and unchecked lending activities of BES, were seen as an impediment to Portugal's securing a high auction price for the institution.

IV. THE BRIDGE BANK: NOVO BANCO

Novo Banco recently reported a first-half loss of almost €252 million, mostly because of the cost of writing off interest payments from big corporate loans inherited from BES.

Novo Banco also had to state provisions for the loss of value in some of its telecommunications holdings.

With ‘unquantifiable liabilities’ noted by Novo Banco’s auditors PwC, mainly due to pending legal actions

V. NEXT STEPS

- BOP has temporarily shelved the sale of Novo Banco;
- none of the proposals, according to the BoP, met the conditions on price and risk;
- the sale was postponed after the government elections (4 October) and stress tests (uncertainty about capital requirements for Novo Banco);

V. NEXT STEPS

- ongoing restructuring of Novo Banco in order to optimise its balance sheet and reinforce its own capital: Novo Banco intends to focus on its core banking business and dispose of non-strategic assets;
- relaunch of the sale process in the future in the hope of achieving a higher price;
- Novo Banco must be sold within two years (August 2016), but the period can be extended by periods of a year if it is deemed in the public interest.

BES/NOVO BANCO: resolution measures

Filipe Santos Barata

fsbarata@gomezacebo-pombo.com

The Consultation Document covered bonds in European Union

- The consultation paper address a framework for a insolvency/resolution regime.
- In the consultation paper it is stated, that the framework could provide:
 - A direct claim against the cover pool on an absolute priority basis
 - A full recourse claim against the issuer for timely payment
- According to the Consultation Document the key to the effective implementation of the dual recourse principle is a robust insolvency and resolution regime that ensures the segregation of the cover assets upon insolvency/resolution of the Issuer

Transparency of legal structure of covered bonds

Relevant issues for the debat on whether or not a harmonized framework should be created

