

**20th Central European Covered Bond Conference – Panel 1**

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# **RESOLUTION AND COVERED BONDS**

***HOW TO GET PREPARED FOR A CRISIS SITUATION?***

Munich 27 / 28 October 2016

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## 1. LEGAL BACKGROUND

**Directive 2014/59/EU** of the European Parliament and of the Council of 15 May 2014, which establishes the framework for the *recovery* and *resolution* of credit institutions and investment firms ("**BRRD**")

**AND**

**Regulation (EU) No. 806/2014** of the European Parliament and of the Council of 15 July 2014 establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Resolution Fund and amending Regulation (EU) No. 1093/2010 ("**SRMR**")

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## 2. RESOLUTION as a special procedure to be applied:

- (i) in a "failing or likely to fail" scenario (*Art. 18(1)(a) and (4) of the SRMR*);
- (ii) where there is no reasonable prospect that alternative measures can prevent failure within a reasonable time frame (*Art. 18(1)(b) of the SRMR*); and
- (iii) in order to achieve the resolution objectives (*Art. 14 of the SRMR*) which cannot be met likewise under "normal" insolvency proceedings (*Art. 18(1)(c) and (5) of the SRMR*).

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**“COVERED BONDS”**: “(...) issued by a credit institution [**bonds issued by credit institutions**] which has its registered office in a Member State and is subject by law to special public supervision [**subject to special public supervision**] designed to protect bondholders (...) sums deriving from the issue of those bonds shall be invested in accordance with the law in assets which, during the whole period of validity of the bonds, are capable of covering claims attaching to the bonds [**secured via covered assets, which are insolvency protected**] and which, in the event of failure of the issuer, would be used on a priority basis [**CBs secure investors in case of INSOLVENCY of the issuer**] for the reimbursement of the principal and payment of the accrued interest.

[Article 52(4) of Directive 2009/65/EC of the EP and of the Council of 13 July 2009 – UCITS Directive, as amended)]

The fact that CBs secure investors in case of insolvency of the issuer is the core of the protection granted by CBs BUT the resolution powers of the resolution authorities take place before the insolvency of the issuer.

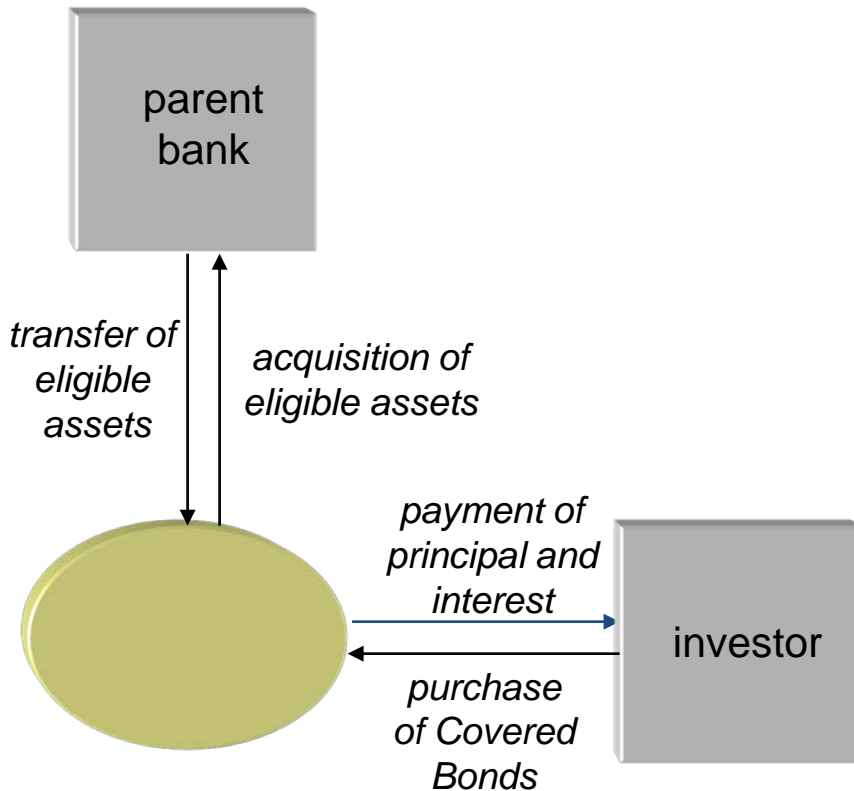
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- At this moment, there is no single legal framework for covered bonds in the EU.
- European Commission public consultation on covered bonds available at [http://ec.europa.eu/finance/consultations/2015/covered-bonds/index\\_en.htm](http://ec.europa.eu/finance/consultations/2015/covered-bonds/index_en.htm).
- The consultation falls under the scope of the Capital Markets Union project and evaluates signs of weaknesses and vulnerabilities in national covered bond markets as a result of the crisis, *with a view to assessing the convenience of a possible future integrated European covered bond framework.*

## COVERED BOND MODELS IN EUROPE

Covered Bond issuer is completely specialised funding institute: France, Ireland

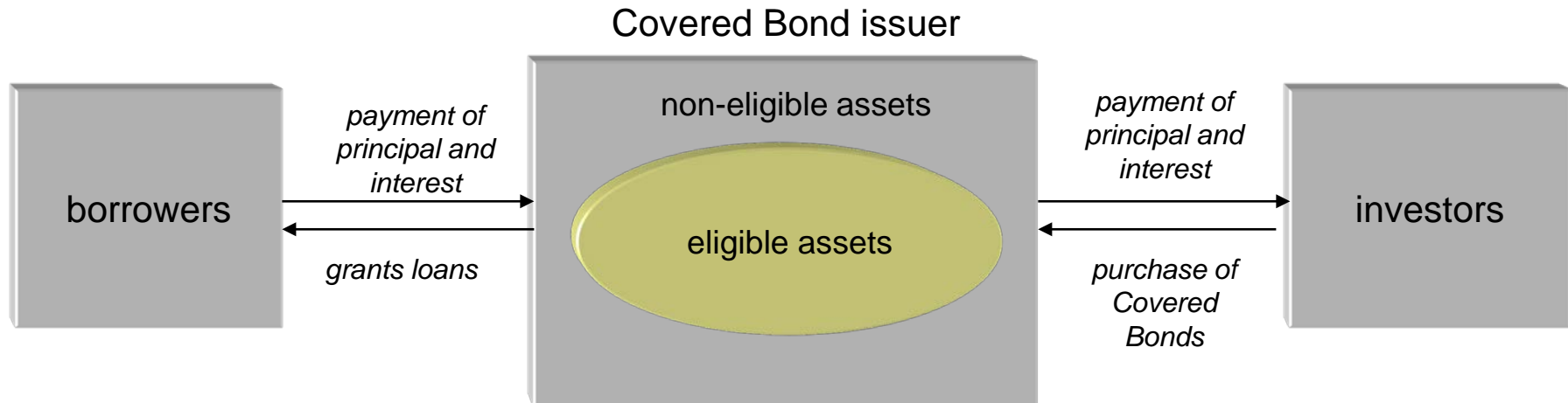


- Origination and servicing of eligible assets and management of Covered Bond issuing institute by parent bank or other parent institution
- Funding institute has no other function than holding (or mainly holds) eligible assets
- Issuer has the legal status of a credit institution
- Issuance governed by special legal framework
- Issuer has no or almost no staff
- Decisive = insolvency segregation of CB issuer from parent bank

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Model 2

**Covered Bond issuer is specialized credit institution by law: Denmark, Hungary, Luxemburg, Norway, Poland**



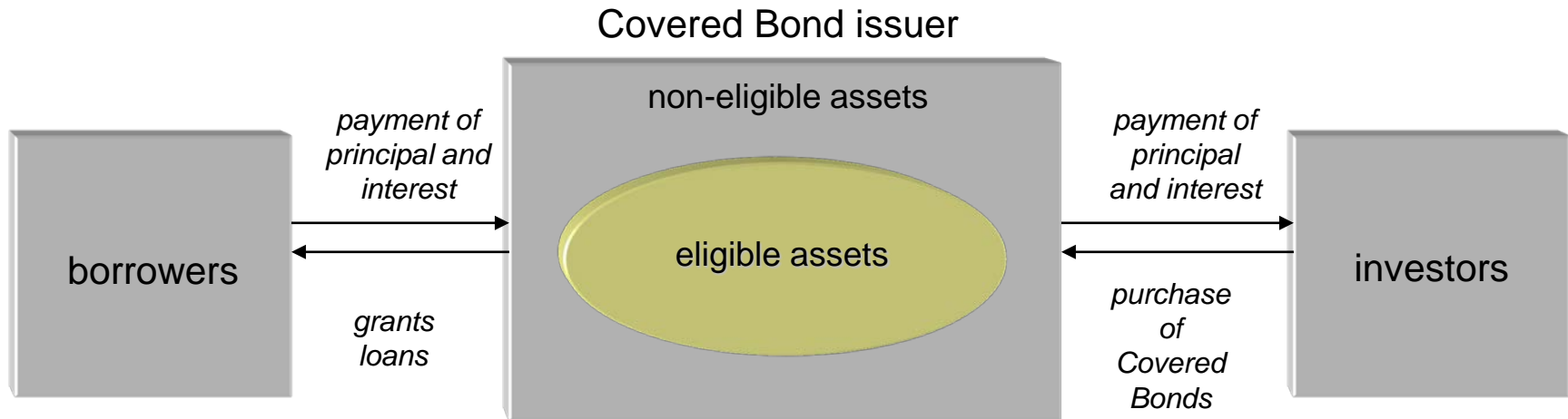
- Issuer originates, services and funds eligible and non-eligible business
- Loan origination restricted by law to mortgages and public-sector loans
- Issuer has the legal status of a credit institution
- Issuance governed by special legal framework
- Decisive = insolvency segregation of cover assets from insolvency estate

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Model 3

## Covered Bond issuer is universal credit institution

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



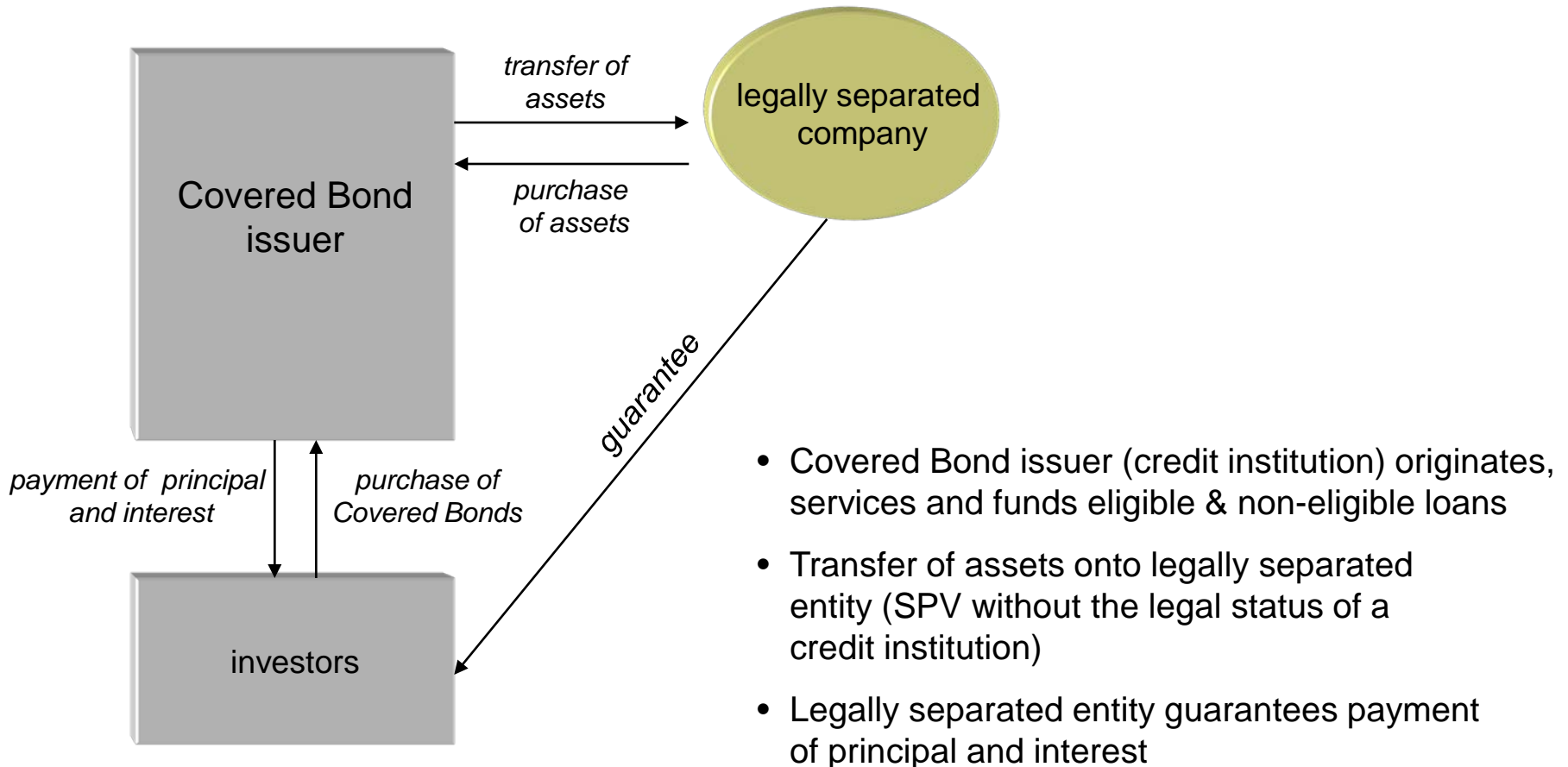
- Issuer originates, services and funds eligible and non-eligible business
- Strict eligibility criteria apply to eligible cover assets
- Issuance governed by special legal framework
- Decisive = insolvency segregation of cover assets from insolvency estate



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Model 4

**Covered Bond issuer is using SPV to achieve insolvency segregation of cover assets: Italy, Netherlands, UK**



- Covered Bond issuer (credit institution) originates, services and funds eligible & non-eligible loans
- Transfer of assets onto legally separated entity (SPV without the legal status of a credit institution)
- Legally separated entity guarantees payment of principal and interest

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## BACKGROUND

The Banking Union (BU) is composed of 3 (three) pillars:

- 1. FIRST PILLAR:** centralised supervision of banks in the euro area under the Single Supervisory Mechanism (**SSM**), under which *Significant Institutions* are supervised directly by the ECB;
- 2. SECOND PILLAR:** Single Resolution Mechanism (**SRM**, established by Council Regulation (EU) No 1024/2013, 15 October 2013), which centralises responsibility for resolution planning and resolution decisions for significant and cross-border banks within the SRB.
- 3. THIRD PILLAR:** EU Commission's proposal for a European Deposit Insurance Scheme (EDIS) in the Banking Union area (currently under discussion by the European Parliament and EU Council).

### **RESOLUTION TOOL-KIT** *(BRRD / SRMR)*

- (i) SALE OF BUSINESS** *(Article 38/39 BRRD / Article 24 of SRMR) : selling the bank or parts of the bank*
  
- (ii) BRIDGE INSTITUTION** *(Article 40/41 BRRD / Article 25 of SRMR): setting up a bridge institution*
  
- (ii) ASSET SEPARATION** *(Article 42 BRRD / Article 26 of SRMR) : separating good assets from bad ones*

(i), (ii) and (iii) are the so called 3 “*Transfer Tools*”

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**(iv) BAIL-IN** (*Article 43/44 BRRD/ Article 27 of SRMR*) : *bailing in shares (write down) and debt instruments (creditor claims are reduced or converted into equity)*

*Express exclusion from bail-in powers: **secured liabilities including covered bonds** and hedging instrument liabilities of the covered bond issuer, although covered bonds are only excluded from the bail-in powers to the extent of the value of the assets securing those liabilities, i.e., any amount of liability in excess of the value of the secured assets will be treated as unsecured and subject to bail-in powers.*

Therefore, PARTIAL WRITE-DOWN OF CBs IF LACK OF COVERAGE

**BUT**

*as per the SRMR (article 27, no. 4, 2<sup>nd</sup> paragraph), **the SRB shall ensure that all secured assets relating to a covered bond cover pool remain unaffected, segregated and with enough funding.***

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## **RECOVERY PLANNING** (*Article 5 / 6 BRRD*)

**Banks** are required to prepare “recovery plans”, a separate process from resolution planning, which identify appropriate options that can be executed in the event of a significant financial deterioration of the institution, thereby reducing the need to take a resolution action.

BRRD requires institutions to prepare “recovery plans”

- i. involve the identification of options aimed at restoring the viability of the entity in the event of a significant deterioration of the institution’s financial position;
- ii. subject to review by both the competent authority and the resolution authority to ensure the credibility of the proposed recovery options.

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### **RESOLUTION PLANNING** (*Article 10 BRRD / Article 8 SRMR*)

In order to ensure that institutions can be *resolved in an orderly fashion*, i.e., in order to ensure resolution readiness the national banks are required to undertake an *ex-ante* resolution planning process, which is an essential component of effective resolution.

The resolution plan shall set out *options for applying the resolution tools and resolution powers*.

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**The Resolution Plan shall include, *inter alia* whenever appropriate and possible (Article 10 BRRD / Article 8(9) of the SRMR):**

- *a demonstration of how **critical functions** and **core business lines** could be legally and economically separated, to the extent necessary, from other functions so as to ensure continuity upon the failure of the institution;*
- *detailed description of the **assessment of resolvability**;*
- *a description of the processes for determining the value and marketability of the **critical functions, core business lines and assets of the institution**;*
- *a detailed description of the **different resolution strategies that could be applied**;*
- *the minimum requirement for **own funds and eligible liabilities** required and a deadline to reach that level, where applicable;*
- *a description of **essential operations and systems for maintaining the continuous functioning of the institution's operational processes**;*

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## QUESTIONS FOR THE PANEL



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## QUESTIONS FOR THE PANEL

1. Can we say that “special public supervision” of CB issuers includes the need to see a crisis in advance? If yes, how can this be achieved and what is being done at EU level in this respect?”

# Resolution and CBs – How to get prepared for a crisis situation ?

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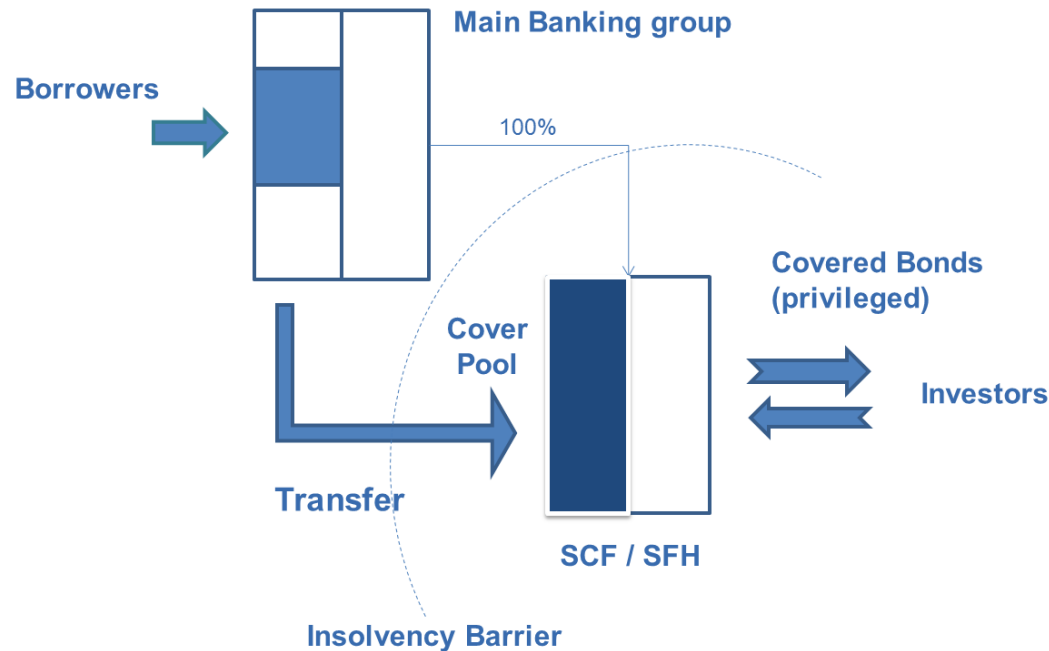
# CB - How to get prepared for a crisis situation ?

We can think, concerning the preparation of crisis situations, of **at least four core principles** :

- ❑ 1. **Strong and clear asset segregation ;**
- ❑ 2. **Flexibility ;**
- ❑ 3. **Operational Plans ;**
- ❑ 4. **Constant special public supervision.**



# 1. Strong and clear asset segregation



French covered bond system is based on the existence of specific credit institutions (SCF or SFH), disconnected from the sponsor.

It allows a clear identification of the pool of loans that covers the issuance of the bonds. **The structure is conceived in such ways in order to allow an operational continuity in the event their sponsor would default.**

## 2. Flexibility

French system based on a separate issuer allow different scenarii in order to adapt to specific situations :

- The SCF/SFH could survive its mother bank's insolvency/resolution and continue its activity ;
- The SCF/SFH could also enter resolution procedures as the same time as its mother bank.

Any harmonisation in the area of resolution/insolvency procedures should then take into account specificities in order to maintain this kind of flexibility.



# 3. Operational Plans

In order to facilitate the process of separation of the issuer from its mother bank, **French law requires SCF and SFH to deliver a specific operational plan** in order to assess how this separation would go on and what would be needed.

This operational plan has to be updated on a yearly basis. It is transmitted to the ACPR.

**Recovery plan from parent company also include a strategy of separation** between the two entities in case of resolution.



# 4. Constant special public supervision

**Public supervision has to be constant** : French covered bonds issuers being specific credit institutions, they are subjected to special public supervision every step of the way.

The special public supervision would in particular still be carried out by the ACPR if the SCF/SFH was to enter a resolution/insolvency procedure.

**Public supervision has to be special** in order to face specific needs : French requirements for SCF/SFH include specific reportings which aim at delivering relevant information for the supervisor in case of a crisis situation (evolution of the cover pool in the long-term ; amount of eligible assets detained by the sponsor bank ; amount of liquid assets owned by the SCF/SFH...).



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### QUESTIONS FOR THE PANEL

2. Which of the resolution objectives (continuity of critical functions, financial stability, etc., cf. Article 14(2) of the SRMR) can be affected by a financial institution's covered bond business?
3. What are the challenges of bailing-in CBs in case of undercollateralisation?





Single  
Resolution Board

## **Flow chart: Pfandbriefe in resolution**

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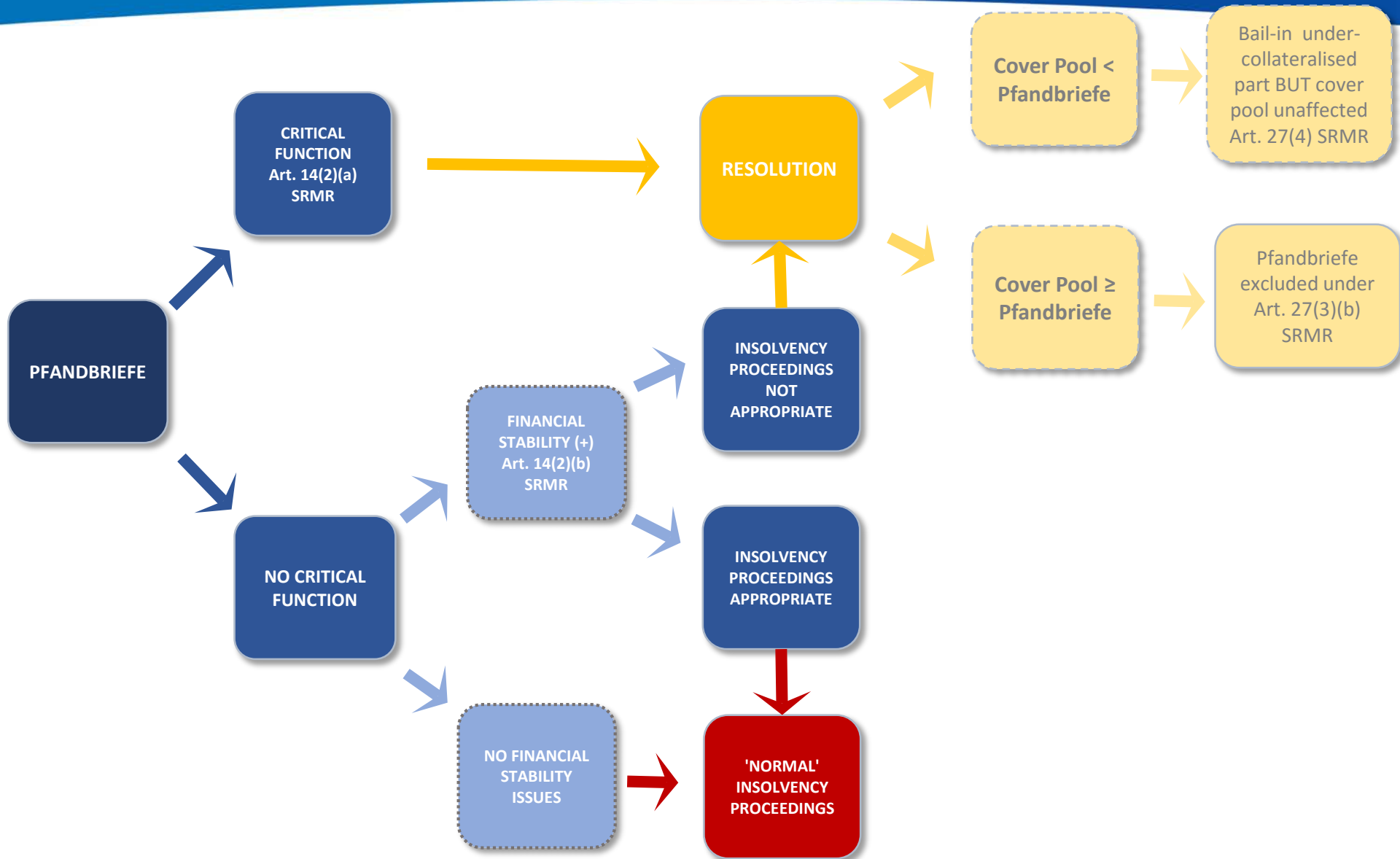
Munich

Sascha Schuff

# Caveats

- It should be noted that the flow chart depicts the main factual alternatives only. However, factual questions can potentially be multiplied through various dimensions:
  - ✓ First, any 'Pfandbrief'-related issue can occur in either of the four Pfandbrief-categories (real estate, public debt, shipping, aircraft).
  - ✓ Second, the chart focusses on a bank that has no systemic relevance (leaving Pfandbrief aspects aside). However, in respect of a bank having additional critical functions or otherwise posing a threat to financial stability, similar issues may arise.
- The analysis focusses on the bail-in tool. It does not look into further resolution tools.

# Pfandbriefe in resolution



# Pfandbriefe in resolution – legal background

## (selected aspects)

- Art. 18(1) SRMR lists the basic conditions to resolution: FOLTF, no alternative measures available, positive public interest test ("PIT").
- PIT is further defined in Art. 18(5) SRMR: PIT (+), if resolution action is necessary for the achievement of and is proportionate to one or more resolution objectives and 'normal' insolvency proceedings would not meet those resolution objectives to the same extent.
- Resolution objectives are listed in Art. 14(2) SRMR: continuity of critical functions, avoid significant adverse effects on financial stability, protect public funds, protect depositors, protect client funds and client assets.
- Art.14(3) SRMR: resolution objectives are, generally, of equal significance and shall be balanced to the nature and circumstances of each case.
- Art.14(2), final sentence SRMR: When pursuing the resolution objectives, the SRB, the Council, the Commission and, where relevant, the national resolution authorities, shall seek to minimise the cost of resolution and avoid destruction of value unless necessary to achieve the resolution objectives.

# Pfandbriefe in resolution – legal background

## (selected aspects)

- Art. 27(3)(b) SRMR: secured liabilities including covered bonds and liabilities in the form of financial instruments used for hedging purposes which form an integral part of the cover pool and which, in accordance with national law, are secured in a way similar to covered bonds are generally excluded from the scope of the bail-in tool.
- Art. 27(4), sub-paragraph 1 SRMR: counter-exemption: bail-in possible to the extent there is under-collateralisation.
- Art. 27(4), sub-paragraph 2 SRMR: The Board shall ensure that all secured assets relating to a covered bond cover pool remain unaffected, segregated and with enough funding.

# Disclaimer

The presentation does not represent an official position of the SRB on the points discussed and shall not be understood or quoted as such. It reflects personal views of the author and speaks as of its date only.

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### QUESTIONS FOR THE PANEL

4. What could be done in good times to get prepared for a real crisis situation, when CB law would have to be fully applied, meaning that CBs and cover pools would have to become ring-fenced stand alone units?

## PREPARATORY MEASURES OF A PFANDBRIEF BANK FOR A COVER POOL ADMINISTRATOR SCENARIO

1. Inspection / securing of the cover asset pool
2. Cover pool calculation
3. Cover pool relevant core system(s)
4. Staff and other resources
5. Cash flow of assets
6. Secure cover pool assets in non-EU/non-EEC states
7. Refinancing Register



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## QUESTIONS FOR THE PANEL

5. How to ensure timely payments to bondholders within resolution procedures?

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### QUESTIONS FOR THE PANEL

6. Is special national CBs legislation sufficient when dealing with resolution scenarios? How to safeguard a level playing field for all CB issuers in European Union?