

# The ECBC today and tomorrow

**Patrick Amat**, Chairman, European Covered Bond Council (ECBC) and a member of the board of 3Cif, and **Dr Louis Hagen**, Former Chairman, ECBC, and Executive Director of the Association of German Pfandbrief Banks, explain the role of the ECBC in the fast-developing world of covered bonds

The European Covered Bond Council (ECBC) was formed some three years ago and now has almost 90 members. During the ECBC's lifetime, the covered bond market has expanded enormously in terms of both its volume and its geographical reach. Given the current uncertainty in credit markets, it is important that the outstanding reputation of this asset class be secured for the future.

## Covered bonds – international significance

Covered bonds represent one of the most dynamic segments in the European bond market. By the end of 2006, the volume of bonds outstanding had reached €1,914 billion and thus a new record; initial sales in the jumbo segment alone amounted to €160 billion.

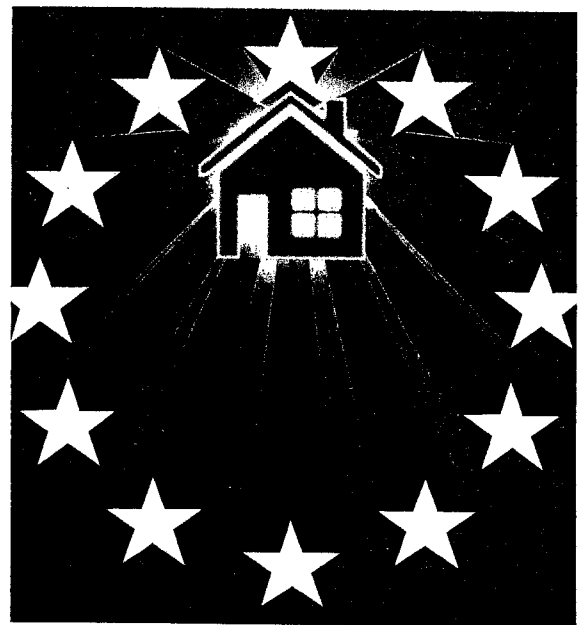
Covered bonds, which originated in France and Denmark and, lastly but by no means least, with Germany's *Pfandbrief*, began spreading into the international arena with the introduction of the Jumbo *Pfandbrief* and the accompanying internationalisation of the investor base. Many new covered bond products emerged in an initial wave of innovations shortly before the turn of the millennium. As the new Basel Capital Standards (Basel II) took shape, from 2003 on more and more countries jumped on the bandwagon with their own covered bond products in order to give their banks access to this attractive funding option. The issuance of the first structured – i.e. contract-based – covered bonds in the United Kingdom in 2003 injected further momentum into the career of this particular asset class. In 2006 the enthusiasm crossed the Atlantic and the first covered bond to come from a US issuer was placed on the market. These milestones illustrate that it was already high time for establishing a single European

platform for the covered bond industry when, in autumn 2004, the go-ahead was given for the establishment of the EMF's ECBC. In view of the diversity and dynamism of the market, it had become necessary for the industry to speak with a single voice in its advocacy dealings with market participants, regulators and the EU institutions in order to defend the interests of this still young asset class at the European and international levels.

## What is a covered bond?

Finding a standard definition for the covered bond was on the ECBC's agenda as a matter of course from the time of its establishment by the European Mortgage Federation (EMF). All issuers of covered bonds are keen to protect their market, and, moreover, their shared 'brand', from harm inflicted by third parties and are investing heavily in safeguarding the high quality and smooth functioning of their markets. However, unlike most national products such as Germany's *Pfandbrief* or Luxembourg's *Lettre de Gage*, the 'covered bond' designation is no trademark protected by law. In theory therefore, any issuer is at liberty to designate a bond a covered bond.

There is likewise no legal definition. The requirements for covered bonds laid down in the Capital Requirements Directive (CRD) apply only to bonds that qualify for preferential treatment in connection with capital adequacy. Bonds not meeting the eligibility criteria do not qualify for the privileges, but they do not thereby forfeit the possibility of being able to be designated covered bonds. National legislation on covered bonds in some countries permits the issuing of such bonds that are not CRD-compliant but which nevertheless enjoy national designation protection. A definition of the covered bond would introduce clarity and pre-



vent 'free riders' from exploiting the positive image of the covered bond brand to promote sales of their own products.

## Standardisation or diversity?

To move closer to arriving at a possible definition of covered bonds, the ECBC's Technical Issues Working Group first thoroughly analysed and compared the existing models considered by the market to be covered bonds. The findings of these studies were set out in national reports based on a detailed questionnaire that gave an impressive overview of the various models in existence. This work was posted on the ECBC website and published in the ECBC's *Covered Bond Fact Book*. This information offers investors an unprecedented degree of transparency in terms of the various products available and, as such, qualifies in its own right as a success in assuring quality in the market.

In addition, for issuers the process has led to a better understanding of the

various products and a common interpretation of issues of decisive importance. It has become clear that the various covered bond models are all geared to offering investors the highest possible degree of security but that the mechanisms deployed to achieve such security differ, in some cases vastly, not least because of the different legal contexts within which these models are embedded. This diversity makes it very difficult to agree on a standard definition of covered bonds. Moreover, such a definition would jeopardise the market diversity so appreciated by investors and curb the healthy competition between the different systems. In the final analysis, what is decisive for investors is the quality of the product they are buying, irrespective of the ways in which that high quality is achieved. Moreover, investors have to have the possibility of scrutinising quality.

The ECBC's publications offer a high level of transparency for such purposes. Investors can take informed investment decisions based on their own research and with the support from the covered bond analysts working with rating agencies and investment banks.

Instead of proposing a definition of covered bonds, the ECBC has therefore decided to agree on the core features that are determinants of quality in covered bonds and has identified four such core features:

- Covered bonds are issued by – or bond holders otherwise have full recourse to – a credit institution which is subject to public supervision and regulation;
- Covered bond holders have a claim against a cover pool of financial assets in priority to unsecured creditors of the credit institution;
- The credit institution has the ongoing obligation to maintain sufficient assets in the cover pool to satisfy the claims of covered bond holders at all times; and
- The obligations of the credit institution in respect of the cover pool are independently supervised.

These core features are supplemented by detailed explanations contained in separate appendices, e.g. on insolvency law and the nature of the supervision. They were officially adopted by all members of the ECBC at its plenary meeting held in Berlin in mid-September 2007.

### The current state of play

The current financial market crisis has demonstrated the benefits that exist for all those involved in the covered bond market of having an organisation such as the ECBC speaking out on behalf of the whole industry.

In order to strengthen its role as the voice of the covered bond industry, the ECBC will continue to seek to develop its membership so as to include representatives from all European countries in which covered bonds are issued. Furthermore, since the concept of the covered bond now stretches well beyond the borders of Europe, the ECBC will also look to welcome issuers from non-EU member states. On the basis of this wide recognition, the ECBC will maintain its position as a privileged contact of the European institutions on all matters related to covered bonds.

The transposition of the CRD into national legislations has not yet been completed, nevertheless new deadlines are already appearing on the horizon and, in particular, that of 2010 when key aspects of the CRD, such as the LGD (loss given default) rates and the eligibility of residential mortgage-backed securities (RMBS) in cover pools, are to be re-discussed. An ongoing dialogue will therefore be maintained with the European institutions, and the ECBC will continue its policy of inviting national regulators to its plenary meetings, which represent an ideal opportunity for them to communicate directly with the industry as well as with each other.

The ECBC's Technical Issues, Fact Book and Statistics Working Groups will continue their efforts, as will the Rating Agencies Working Group; given that covered bonds are continually changing, it is perfectly normal that the rating agencies' methodologies will change accordingly. This group will provide rating agencies with all contributions and comments as may be necessary in order to contribute to improving their proposed methodologies, particularly with regard to the availability of requested information. If deemed necessary, the Steering Committee of the ECBC will adopt policy positions on the methodologies proposed by the rating agencies.

The ECBC's Market Related Issues Working Group will have a difficult and urgent task: covered bonds are rightly marketed as a very high-quality asset class, but the very high quality cannot be limited to the quality of credit: it must also extend to all matters related to market techniques and transactions. This

quality is a prerequisite for investors. Issuers and banks active in the market must comply with this requirement, even if their immediate interests are sometimes divergent. The Working Group will be a forum for discussion between them and will focus its work on achieving the necessary long-term improvements that will be the basis of the recommendations made by the ECBC.

The immediate work of the group will concern the best ways of ensuring the liquidity of covered bonds, including market-making. Recent events have shown that the existing systems are diverse and could be improved, and that at least one common definition of the principal concepts is necessary.

Similarly, the events of this summer showed that in a crisis situation, market players needed an organisation that could give immediate guidance to the markets on behalf of issuers and market-makers. The ECBC has therefore established the '8-to-8' Issuers & Market-Makers Committee which brings together eight issuers from eight different European countries and eight investment banks representing the market-making community. This committee will meet in times of crisis and is instructed by the ECBC to give very specific guidance on the path to be taken and the best ways to ensure a return to normal market conditions.

At the time of writing, the '8-to-8' Committee has already met twice and issued a clear statement on its own assessment as to the current state of play on 5 October 2007. The committee will continue to monitor market conditions until such time as they return to normal. Furthermore, the '8-to-8' Committee will seek to build upon the technical work of the Market Related Issues WG in order to assist its own work and reflections.

To ensure maximum effectiveness, the work of the ECBC and its working groups will be published as it progresses. The quality and remarkable success of the annual ECBC/Euromoney Covered Bond Congress makes the event a key element in this mechanism and the ECBC's participation will therefore be enhanced for the September 2008 edition of the Congress.

Finally, all these exciting and ambitious projects are made possible thanks to the EMF/ECBC Secretariat, which coordinates, facilitates and enhances the work of the ECBC. We thank the European Mortgage Federation for making this efficient, professional team available to the ECBC. **MFG**