

# The Impact of the Bank Recovery and Resolution Directive's (BRRD) Bail-in Tool on Covered Bonds

DISSERTATION

der Rechtswissenschaftlichen Fakultät  
der Universität Zürich

zur Erlangung der Würde einer Doktorin der Rechtswissenschaft

vorgelegt von

**Verónica Pollaková**

von  
Chile

genehmigt auf Antrag von  
Prof. Dr. Samuel Kern Alexander  
und  
Prof. Dr. Aline Darbellay Suso

Schulthess Juristische Medien AG, Zürich

# Table of Contents

<b>List of Tables</b> .....	<b>XIV</b>
<b>List of Figures</b> .....	<b>XV</b>
<b>List of Equations</b> .....	<b>XVI</b>
<b>List of Abbreviations</b> .....	<b>XVII</b>
<b>Chapter 1 Introduction</b> .....	<b>1</b>
I.    Setting the context.....	1
1.    The new supervisory framework .....	10
2.    The Banking Union.....	12
3.    The strength of capital and liquidity buffers .....	14
II.   Research questions .....	18
III.  Literature review .....	19
1.    Overview .....	19
2.    Filling the gap.....	25
IV.  Research design: questions, structure and development.....	26
V.   Research methodology .....	28
<b>Chapter 2 Disclosing the Universe of Covered Bonds</b> .....	<b>31</b>
I.    Introduction .....	31
II.   History and evolution of covered bonds.....	32
III.  A perspective into the space of financial instruments .....	40
1.    The classification of financial instruments .....	40
2.    The legal definition of financial instruments, transferable securities, secured liabilities and covered bonds.....	43
IV.  Splitting of covered bonds as legislative and contractual (or structured) .....	46
V.   Legislative covered bonds' common patterns .....	48
1.    Depicting the claims mode according to the issuance mode.....	50
1.1  Issuance through a universal credit institution .....	51
1.2  Issuance through a specialized credit institution .....	53

1.3	Issuance through a universal credit institution with special license and transfer of collateral assets to an SPE or SPV which guarantees covered bonds .....	56
2.	Drawing the safety and the supervision mode .....	58
2.1	Covered bonds' collateral assets .....	59
2.2	OC-Level.....	62
2.3	Derivatives in the cover pool.....	64
2.4	Covered bonds' supervision and cover pool monitoring .....	65
3.	Discussion: why structured covered bonds do not necessarily align with legislative covered bonds' common patterns? .....	67
VI.	Covered bonds' structures for liquidity risk mitigation .....	68
1.	Hard-bullet structure.....	69
2.	Soft-bullet structure .....	70
3.	Pass-through structure.....	70
4.	Comparative analysis of covered bonds' structures .....	71
VII.	Concluding remarks .....	72

**Chapter 3 An Insight into the BRRD, its Bail-In Tool and its Impact on Covered Bonds..... 75**

I.	Introduction.....	75
II.	General remarks on the BRRD.....	76
1.	The foundations of the BRRD .....	76
2.	The enforceability of the BRRD .....	79
3.	The scope and authorities of the BRRD.....	81
4.	Who bears the losses first? The “no creditor worse off principle” at the intersection of the resolution financing arrangements: defining a maximum level of loss.....	87
III.	The BRRD procedure.....	90
1.	The recovery framework.....	93
1.1	Preparation .....	93
a	Recovery and resolution plans .....	94
b	Assessment of resolvability .....	96
c	Intra-group financial support .....	97
1.2	Early intervention .....	99
a	Early intervention measures.....	100
b	Removal of senior management and management body....	102
c	Appointment of one or more temporary administrators .....	102

2.	The resolution framework and the resolution tools.....	106
a	The sale of business tool.....	109
b	The bridge institution tool.....	110
c	The asset separation tool.....	111
d	The bail-in tool .....	114
1.	Limits to the exercise of the bail-in tool .....	115
2.	Use of resolution financing mechanisms .....	118
3.	Right of appeal.....	119
IV.	Does the recovery and the resolution framework affect covered bonds and, if so, how? .....	121
1.	The resolution tools and covered bonds.....	122
1.1	The sale of business tool and covered bonds.....	122
a	Covered bonds as liabilities .....	122
b	Covered bonds as assets.....	123
1.2	The bridge institution tool and covered bonds .....	123
a	Covered bonds as liabilities .....	123
b	Covered bonds as assets.....	124
1.3	The asset separation tool and covered bonds.....	125
1.4	The bail-in tool and covered bonds. Clarifying bail-in of covered bonds.....	125
2.	The appeal right and covered bonds .....	131
3.	Concluding remarks.....	131

## **Chapter 4 Covered Bonds Regulatory Considerations .....135**

I.	Introduction.....	135
II.	The extension of the prudential investment limits and the risk weight preferential treatment .....	136
1.	Raising the 5% prudential investment limit to invest in transferable securities and covered bonds of a single issuer.....	137
2.	Covered bonds risk weight preferential treatment according to Article 129(4) and (5) of Capital Requirements Regulation (CRR).....	139
2.1	Covered bonds' collateral assets eligibility according to Article 129(1) of CRR.....	142
2.2	Covered bonds' regular portfolio information requirements according to Article 129(7) of CRR .....	144
III.	Capital and Liquidity under Basel III: an incentive for covered bonds market	145
1.	Basel III capital requirements, bank structure and management.....	145

2.	The Liquidity Coverage Ratio .....	148
3.	The Net Stable Funding Ratio.....	153
IV.	Concluding remarks .....	155

**Chapter 5 Final Conclusion and Contribution .....157**

I.	Introduction.....	157
II.	The key findings: the essentials of Chapters 2, 3 and 4.....	157
1.	Covered bonds are used to finance and refinance private and public sector debt; since 2009 they are used as part of the ECB's QE program. ....	157
2.	Covered bonds are a set within the class of secured liabilities.....	158
3.	While legislative covered bonds share common patterns, structured or contractual covered bonds do not. However, both are within the class of secured liabilities. ....	158
4.	Covered bonds benefit issuers and holders .....	159
5.	Covered bonds are bankruptcy remote, but this doesn't mean they cannot face insolvency.....	159
6.	Covered bonds with high quality collateral assets and soft-bullet structures are essential for covered bonds positive performance and resilience after a stress period. ....	159
7.	Covered bonds with soft-bullet structures are the ones that better align liquidity risk mitigation with management risk and payment risk. ....	160
8.	While the recovery framework does not impact covered bonds, the resolution framework does.....	160
9.	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 according to national law are secured in a way similar to covered bonds, ie derivatives, are excluded from bail-in.....	161
10.	Current EU regulation is an incentive for legislative covered bonds' market. ....	161
11.	Basel III encourages covered bonds' market. ....	162
III.	Discussion: intersecting the key findings .....	163
1.	The new covered bond regulation provides better protection to investors.....	163
2.	The new covered bond regulation promotes investors' confidence about using covered bonds as a funding instrument. ....	163

3.	The new covered bond regulation enhances issuers' balance sheet expansion.....	164
4.	The new covered bond regulation tends to move contractual covered bonds away.....	164
IV.	The research questions and their answers.....	164
1.	To determine whether the BRRD's bail-in tool affects or not affects covered bonds.....	165
2.	Related to the former question, to analyse whether covered bonds are seen as optimal instruments for banks to issue or not. ....	166
3.	To assess whether covered bonds' issuance should be encouraged or not under the new recovery and resolution regime. ....	166
V.	Filling the research gap .....	166
VI.	Further research.....	169
VII.	Recommendations .....	170
VIII.	Ethical research .....	170
	<b>Bibliography.....</b>	<b>171</b>

## List of Tables

Table 1: Basel III phase-in arrangements. All dates are as of 1 of January.....	16
Table 2 Status of the BRRD’s transposition as of 2 June 2016.....	80
Table 3 Competent and resolution authorities in countries where the BRRD is fully implemented. ....	83
Table 4: Table 6a of Article 129(4) of CRR.....	139
Table 5 Correlation between rating and risk weight of covered bonds when the credit assessment by a nominated External Credit Assessment Institution (ECAI) is available.....	140
Table 6: Correlation between covered bonds’ rating and risk weight when the credit assessment by a nominated ECAI is not available.....	142
Table 7: Observation period and the introduction of the Liquidity Coverage Ratio (LCR) minimum standard.....	149
Table 8: Asset categories and associated RSF factor.....	154

## List of Figures

Figure 1: The European System of Financial Supervision (ESFS) structure .....	11
Figure 2: The Banking Union structure .....	12
Figure 3: Total covered bonds outstanding from 2003 to 2014 per underlying assets. ....	36
Figure 4: Overview of European countries with laws governing the issuance of covered bonds and year of framework introduction. ....	47
Figure 5: Selected core jurisdictions and covered bond name.....	50
Figure 6: Example of a simplified issuance structure through a universal credit institution with special license. ....	52
Figure 7: Example of a simplified issuance structure through a specialized credit institution. ....	54
Figure 8: Example of a simplified issuance structure through a universal credit institution with special license and collateral assets held by a SPE/SPV as guarantor.....	57
Figure 9: Collateral assets allowed in the ten selected core jurisdictions.	60
Figure 10: The BRRD's procedure.....	92
Figure 11: The write down and conversion sequence. ....	117
Figure 12: Bail-in the uncollateralized value.....	127
Figure 13: Reasoning: bail-in the uncollateralized value .....	128
Figure 14: UBS Organizational Structure .....	147
Figure 15: High Quality Liquid Assets.....	151



## **List of Equations**

Equation 1: Liquidity Coverage Ratio formula ..... 150

Equation 2: Net Stable Funding Ratio..... 153