

## **Rationale for Changes to the Asset Covered Securities Act 2001**

The Asset Covered Securities (Amendment) Bill 2007 has been introduced to make various amendments to the original act that established an Irish legislative framework for covered bonds, the Asset Covered Securities Act 2001. The rationale for the amendments includes:

- Introduction of CRD in 2007
- Revised definition Covered Bonds which now replaces the UCITs Directive
- Irish Government, the IBF and participants in the ACS Market wanted to act quickly to ensure that the ACS legislation remained fully CRD compliant.
- To that end, these changes to the ACS legislation will require all ACS issuers to be compliant with the CRD at all times, thus ensuring an enormous degree of transparency for investors as regards the risk weighting of ACS assets under Basel II.
- Where possible the intention has been to enhance investor protections and to that end, the changes ensure that the ACS market is CRD compliant in terms of the definition of a Covered Bond, but they do not go as far as the CRD in terms of eligible assets - ensuring that the credit quality within the pools is maintained.

At the same time, the focus within the ACS market has always been on ensuring that the ACS remained at the forefront of the Covered Bond market and therefore while the CRD changes were taking place an evaluation of where else the ACS legislation could be enhanced was undertaken, resulting in several additional changes. The speed of response of the Irish market, the regulator and the Government and the collegiate nature of Ireland Inc continue to be a key driver in the enhancements of the ACS legislation that are proposed. It is the hope of all in the market that these developments can further strengthen and deepen the ACS market and facilitate the growth of the market by opening up opportunities for new entrants.

The key changes can be split into 3 key areas: Quality of Eligible Assets, Risk Control and Monitoring and Compliance.

### **1. Quality of Eligible Assets**

The developments in the eligible asset criteria have been driven by the increasing desire by investors and rating agencies alike to maintain high quality and well diversified Cover Pools. The changes have taken some of the CRD opportunities to enhance diversification, but maintained a focus on the eligibility of the highest quality credits.

#### **1.1 Public Sector Pools**

- To enhance diversification and credit quality further the 15% restriction on assets from the United States, Canada, Switzerland and Japan has been removed completely.
- In addition, Australia and New Zealand have become eligible countries (both Aaa).
- Multilateral Development Banks have also now become eligible (only the EIB was eligible before).
- It was decided not to include other non-Aaa non-EU countries in the pool to ensure that the overall credit quality of the pool was enhanced and maintained.

#### **1.2 Residential Mortgages**

- Securitised mortgage collateral would become eligible for the pool, enhancing the credit quality and most importantly the liquidity of the mortgage assets in the pool.
- Diversification would become more possible, with the inclusion of mortgages from highly rated countries (USA, Canada, Switzerland, Japan, Australia, New Zealand) outside the EU.

### **1.3 Commercial Mortgages**

- For the first time it will be possible to issue ACS backed by commercial mortgages.
- However, with a focus on credit quality and unlike other legislations, commercial mortgages will have to sit in a wholly separate Cover Pool to residential mortgages.
- This will ensure complete transparency of the asset pools.
- This will also provide an opportunity to deepen the ACS market.

## **2. Risk Control**

There have been several enhancements in this regard.

### **2.1 Legislative Over-Collateralisation**

- In addition to the contractual 5% nominal OC commitment that all ACS issuers currently have with all bondholders, there will now also be an obligation to maintain 3% Over-Collateralisation by law.
- In the case of Public Sector ACS this is measured on an NPV basis.
- In the case of Mortgage Backed ACS this is measured on a nominal value basis.
- This will mean that ACS issuers have a legislative obligation and a contractual obligation to bond holders which must be maintained at all times and which will be enforced by each Issuer's Cover Asset Monitor.
- No other Covered Bond legislation requires issuers to fulfil 2 separate Over-Collateralisation tests.
- The CAM will have oversight of BOTH Over-Collateralisation calculations.

### **2.2 Pool hedge collateral**

- Amendments are being made to the legislation to ensure the transparent and straightforward management of pool hedge collateral.
- This will make the effective use of derivatives to manage interest rate and currency exposures more straightforward for issuers enhancing the matching in the pool for the benefit of bondholders.
- In this amendment, there will be a separate register of pool hedge collateral which will clarify the rights of hedge counterparties - making it easier for issuers to enter into ISDA and CSA agreements for the direct benefit of the cover pool and bond holders.

### **2.3 Changes to duration gap calculation to enhance transparency**

- The initial duration gap calculation (which aimed to express both interest rate risk and maturity mismatches in the pool) proved not to be as transparent as it could be, as different interest rate structures could have different duration treatments.
- Therefore the test has been simplified to ensure transparency.
- Working in tandem with the existing interest rate test that applies to all the assets of the DCI, this test will assess the weighted average time to maturity of the assets and liabilities in the pool.
- This rule will therefore ultimately be stricter than the current rule as differing interest rate treatments will not be allowed to influence the gap.

### **2.4 Reduction in the volume of substitute assets**

- Compliant with the CRD, the volume of substitute assets under these amendments will go from 20% of the pool to 15%.

### **3. Monitoring and Compliance**

The ACS legislation is at the forefront of the market with regard to its monitoring and compliance. The weekly (in the case of DEPFA ACS) and monthly (in the case of all other issuers) reporting of the Cover Pools and DCI information and the real-time monitoring of that data by the Covered Asset Monitor mean that the oversight in the ACS market is stronger than any other Covered Bond market. To that end very few amendments have been made in this regard.

The only changes are:

- Ensuring that the obligations of the CAM(s) to monitor ACS issuers now encapsulates any Commercial Mortgage issuers that enter the market.
- Ensuring that the CAM now has responsibility for monitoring the legislative Over-Collateralisation requirement as well as the existing contractual Over-Collateralisation requirements.

The role of the NTMA as the servicer of last resort has not been amended in the legislation as it remains a corner stone of the ACS market.