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DBRS Commentary: Covered Bonds vs. Securitisation – A Quick Comparison

Covered Bonds (CBs) and securitisation are both used to enable entities to diversify their sources of funding, reduce overall funding costs and recycle capital for further lending. This commentary provides an overview of the basic differences between CBs and securitisation. In this comparison, DBRS focuses on Residential Mortgage-Backed Securities (RMBS) and traditional covered bonds. Structural and traditional differences between the two products remain relevant, despite the introduction of different assets (other than mortgages and public assets) as collateral for senior collateralised bank obligations, reducing the gap between the two products.

Securitisation creates a stand-alone pool of receivables structured to withstand the bankruptcy of the originator and other transaction parties. The cash flows generated by the pool of receivables are used, net of senior fees, in a pre-determined order of priority for the satisfaction of investors, whereas CBs are dual recourse senior debt instruments issued by a going concern entity (the debtor of first recourse) and then additionally secured by a pool of assets (cover pool). Should the debtor of first recourse default on its obligations, investors are to be made whole by the cover pool, administered by a third party.

The most notable differences between a CB and securitisation are summarised as follows:

Dual versus Limited Recourse

CBs are characterised by two lines of recourse that are activated sequentially, first toward the issuer or sponsoring entity (typically a bank) and second, once the entity has defaulted, toward the cash flows generated by the cover pool. As long as the issuer/sponsor remains solvent, the issuer is expected to meet all interest and principal payments due to CB holders. Collections from the cover pool are used for the issuer's general liquidity management needs or for integration of the cover pool with additional assets in order to support further CB issuance. Following a default of the issuer/sponsor, the payment obligations shift to the cover pool as a source of payment to the CB holders. In circumstances where the cover pool proves insufficient to satisfy the claims of the CB holders, there normally remains an unsecured recourse to the general insolvency estate of the issuer/sponsor.

Comparatively, securitisations are intended to be delinked from the repayment capability of the sponsor/seller of the receivables, and liabilities are expected to be met principally by the cash flows of the segregated pool of assets. Any losses beyond those originally implied by the capital structure are to be borne by noteholders. Cash flows from the pool may be prioritised to the various tranches of the securitisation structure such that losses are borne by subordinated noteholders first, and depending upon their magnitude, losses may move up the structure to more senior tranches.

As a result, risk assessment of CBs largely focuses on the issuer, backed up by the collateral pool. DBRS places issuer assessments as a central pillar in its ratings of covered bonds. In contrast, the risk assessment of a securitisation focuses on the ability of the collateral pool to repay the notes in a timely manner. Therefore, DBRS securitisation risk evaluations focus on the collateral pool first.

Recent European regulations implemented via the Bank Resolution and Recovery Directive (BRRD) are aimed at prescribing the process for resolving a bank in the event of insolvency. In this process, CBs are highlighted as having a high seniority in the resolution of a bank and will be treated preferentially over senior unsecured bonds. Securitisation is not typically a direct part of the insolvency of the originator, as the special-purpose vehicle (SPV) would make the structure bankruptcy remote. Agreements and other structural aspects of securitisations are expected to be treated beneficially under certain circumstances, such as swap agreements, servicing undertakings, and to some extent, bank accounts, especially for banks that are large, complex and interconnected, etc. However, while each country will implement BRRD differently, covered bonds are clearly outlined as exempt from bail-in as long as they are collateralised.

Dynamic versus Static

Securitisation asset pools are typically static, though there are some structures that allow revolving pools. For static pools, the pool cannot change except for in very specific cases such as substitutions, repurchases or permitted variations. These are normally done within very strict standards set forth in the transaction's legal documents. When a securitisation pool is revolving, it is typically for a defined period of time, with strict eligibility criteria for new assets to be included in the asset pool. Performance triggers can terminate a revolving period early and are in place to prevent a deterioration in collateral quality from transaction origination as a result of substitution.

By contrast, cover pools are constantly revolving. For legislative covered bonds, eligibility criteria are normally set by law and are more lenient when compared with top-up criteria for securitisations. However, a set of tests still exists to ensure the issuer/sponsor maintains a certain level of quality in the cover pool. As the credit risk of the cover pool is not transferred to investors until the default of the issuer/sponsor, the aim is to maintain good credit quality until that point. In some jurisdictions, the quality of the cover pool is regularly monitored by a third party to ensure maintenance of pool quality.

Here the difference between the two product types lies in the agency risk in the ongoing quality management of the asset pool. In a securitisation, the pool is largely pre-defined with little room for adjustment, whereas a covered bond investor is reliant upon the issuer to ensure maintenance of quality standards and compliance with defined rules.

Collateral

Covered bond collateral focuses on two main products: mortgages (both residential and commercial) and public sector assets. Public sector assets are loans to sub-sovereign entities, local or regional governments, or government-owned entities. These are typically held within segregated CB programmes from the mortgage loan programmes. Mortgage CB programmes are typically residential in focus, but there are some issuers that include some commercial mortgages in the pool, or have a dedicated commercial mortgage CB programme. Smaller in number are CB programmes with shipping loans and more recently, small and medium-sized enterprise (SME) loan pools.

In contrast, for securitisation there is no qualifying nature of the collateral that can go into a securitisation vehicle. The tranching of collateral cash flows and the vehicle's independent nature allow it to contain many different types of collateral. Typically, the main type of collateral for securitisation is the same as CBs: mortgages. But there are many other types of collateral, such as auto loans, equipment leases, credit cards, electricity receivables, consumer loans, aircraft leases, peer-to-peer loans, etc. that are pooled within securitisations.

Credit Enhancement

Credit enhancement in securitisation structures is established at inception and will change over time, depending on the principal repayment of the notes and realised losses from the pool. Typically, as the structure is repaid, credit enhancement will increase for the senior tranches over time. However, some structures allow credit enhancement to remain constant through proportional repayment of the structure. Securitisations are also at risk of decreased credit enhancement if losses build up within the structure.

The main and often only form of credit enhancement in CBs is overcollateralisation (OC). Due to the very nature of the product, OC in CBs is an ever-changing target. OC will vary because of the amount of CBs issued or amortised under the programme, as well as assets added to, or removed from, the cover pool. Therefore, there are different levels of OC an investor should pay attention to in CBs. Generally speaking, the only real obligation of the issuer/sponsor is to maintain a level of assets to ensure compliance with the minimum legislative level of OC. However, issuers then have the ability to choose to commit a higher level of OC toward fostering investor confidence. An OC commitment can be made in various ways; for example, it may be in the form of a contractual undertaking, public statement or internal guidelines. The actual level of OC, normally higher than the committed level, could be viewed as an indication of an issuer's intentions. DBRS assesses OC levels on a case-by-case basis when rating CBs.

Asset Segregation

For CBs, there are different ways in which segregation of the assets from the issuer/sponsor can be achieved: (1) on the balance sheet of the issuer, by virtue of registering the cover pool assets in a dedicated registry; (2) in a dedicated subsidiary of the issuer (which may also be the issuing entity); or (3) in a special-purpose entity via a true sale. For legislative CBs, the law ensures that the cover pool is segregated from the sponsor's estate, or will be segregated at the time of the sponsor's default.

Segregation of a securitised pool is achieved by way of a true sale or equitable assignment according to the general legal framework, or by operation of a dedicated securitisation law in those jurisdictions where it exists. The intention here is to move the assets to an arm's length from the originator, allowing investor possession of the pool. In a securitisation, the collateral risk is typically transferred to an SPV in order to transfer to arm's length. The asset risk is thereby segregated from the balance sheet of the originator and transferred into a bankruptcy-remote entity. However, many sponsors retain equity ownership of the SPV, or strong links to the securitised portfolio via the servicing of the collateral.

Pool Integrity and Tests

Once assets have been transferred to a securitisation vehicle, the performance of the assets is meant to be independent from the sponsor, with the sponsor having no formal obligation to maintain the pool in a performing status. The sponsor may service the assets, acting as an agent of the securitisation vehicle, but it does not normally retain the full credit risk. Recent regulations now require sponsors to retain an interest in the securitisation transaction. As a result, they are incentivised beyond reputational reasons to maximize the performance of the pool of assets, especially if they are exposed to the risk of first loss. If certain

performance triggers are breached, the waterfall may be affected, thereby limiting the performance of the retained portion of the transaction. However, the sponsor is under no obligation to cure a non-performing pool.

For CBs, the issuer/sponsor has a general obligation to maintain both the performance of the cover pool and update the value of the real estate collateral backing the mortgage loans, although updated property values are not a requirement in all countries. Pool performance is important to maintaining CB OC levels and eligibility for future issuance. The amount of CBs that can be issued is normally determined with reference to qualifying collateral. Delinquent or defaulted assets are given a reduced value when determining the amount of qualifying collateral. Valuations of mortgaged properties are typically updated by applying statistical models, and increased loan-to-values could cause certain loans to become fully or partly non-qualifying in most countries.

CB issuers have the obligation to manage both cover pools and the outstanding CBs so that certain tests are satisfied at all times. Such tests may relate to (1) a nominal or net present value (NPV) OC, which is determined based on stressed interest and exchange rate assumptions; (2) cash flow matching tests aimed at ensuring that collections and disbursements are balanced across the life of the cover pool; or (3) liquidity tests aimed at ensuring that the cover pool has sufficient liquid assets to meet payment obligations coming due within a defined time horizon.

As a result, generically, CB pools are managed and monitored while securitisations are serviced. This reiterates the agency risk associated with cover pools because of their ongoing management needs. Securitisation instead relies upon a servicer, separately paid, though this role is usually handled by the original issuer of the underlying loans in order to ensure appropriate management of the asset pool according to the terms of the structure.

Cover Pool Monitor and Regulator

Almost all CB legislations embed the role of a cover pool monitor. A cover pool monitor has varying powers and responsibilities, but its main duty is to ascertain that the assets meet the eligibility criteria set out by the law, all regulatory tests are complied with, and the value of the underlying collateral is still sufficient for its purposes. This role is managed within securitisations by a servicer performing somewhat similar tasks.

CB issuers are constantly under the supervision of a regulator, which in some regions may be the same regulator as for banking. The regulator is responsible for vetting and maintaining the entity as a CB issuer, authorising a CB programme and approving issuance. They will also sanction the issuer when tests are not complied with and/or activate contingency plans ahead of, or upon, a default of the issuer/sponsor.

The role of the CB regulator is assessed within the Legal and Structuring Framework scoring in DBRS's rating methodology. Within the securitisation market, this regulatory oversight does not generally exist. Instead, some jurisdictions have a dedicated securitisation law and may incorporate reference to a regulator. To date, regulatory oversight in securitisation is generally much lower compared with CB, partly because of the lower agency risk. Securitisation regulations instead focus on transaction monitoring and related requirements. For example, loan-level transparency of the collateral, requirement of a back-up servicer, etc.

Static versus Dynamic Issuance

Securitisation notes are typically only issued at closing by the securitisation vehicle, as the structure is typically done on a stand-alone basis. No further issuance against the same pool of assets is to be expected. An exception is the use of master trust structures, where new collateral is added, allowing for new notes to be issued. Other programmatic issuers will create separate securitisations each with unique pools but similar characteristics.

For CBs, the issuer establishes a programme, in some cases with a maximum limit. The issuer will then issue a new series at any time, as long as it fits within the parameters of the regulatory framework and their strategy. This will typically fit within OC parameters, maturity profiles, etc. to ensure the smooth management of the CB programme assets and liabilities.

Tranching and Time Subordination

Tranching and subordination are forms of establishing a priority of payment and introducing credit enhancement used in securitisations. Credit enhancement is determined by the amount of collateral losses that would occur before a principal loss in the notes. When tranching, different classes of creditors are created, and payments from the asset pool are allocated in order of priority, as set out in the terms of the structure. This prioritises cash payments to the more senior classes first (with higher credit enhancement) and then to classes that are more deeply subordinated (with lower credit enhancement).

When losses occur within a securitisation pool, the more subordinated classes act as a buffer for the more senior classes, since losses are applied in a reverse order of priority. Creditors in the same class are normally paid *pari passu* and *pro rata*.

The absence of tranching is the norm for CBs, although some legal frameworks allow junior CBs. The main form of credit enhancement in CBs is the use of OC, which is the difference between the amount of collateral held and the amount of liabilities

in the form of outstanding CBs. After issuer/sponsor default, OC provides a buffer for potential losses to be absorbed before having an impact on the CBs. All series of notes have the same priority and are paid *pari passu* when due at the same time.

However, CBs are not meant to automatically cross-accelerate purely because of issuer/sponsor default. Rather, CBs maintain their expected or extended maturity dates in a post-issuer-insolvency scenario. This causes holders of longer-dated CBs to be subject to the risk of time subordination, as the cover pool may be depleted or its quality may deteriorate by the time longer-dated CBs mature. In order to help mitigate this risk, amortisation tests are embedded in many CB programmes. Following the default of the issuer/sponsor, should the cover pool (according to a specific calculation) no longer be expected to be sufficient in order to repay all CBs in full, CBs are cross-accelerated so shorter- and longer-dated CBs are paid *pari passu* and *pro rata*.

Pass-Through versus Bullet (Market Risk)

In securitisation, the most common form of note is “pass-through,” where loan principal payments are used to repay outstanding notes. Notes are amortised to the extent collections have been received on the underlying assets. Legal maturities of the notes are set at a date where all cash flows from the asset pool are expected to have been collected and redirected to investors. As such, the profile of assets and liabilities is perfectly matched, and there is no expectation that any portion of the asset pool would have to be liquidated to meet maturing liabilities. While protected from the market risk of loan values, investors are still exposed to reinvestment risk dependent upon cash flow timing.

CBs are normally issued as bullet maturities with a date generally much shorter than the maturity of the assets in the cover pool. This generates an asset-liability mismatch. As long as the issuer/sponsor is solvent, it is expected to meet the CB liabilities using refinancing proceeds or its own funds. Following a default of the issuer/sponsor, payment obligation shifts to the cover pool. In this scenario, a third-party administrator is expected to effectuate refinancing of the cover pool, in whole or in part, in order to meet the coming maturities. This exposes the cover pool to market risk, which securitisation does not face.

There have been a few select issuances of pass-through CBs where, following a default of the issuer/sponsor, the maturity of the bonds extends for a period of time so that all cash flows coming from the cover pool can be collected and directed toward the repayment of CB investors before the legal maturity of the bonds; in other words the CBs would become similar to a securitisation structure following issuer/sponsor default. While this frees the cover pool from refinancing risk, it may substantially increase the extension and reinvestment risk posed on CB investors.

Link to the Issuer/Sponsor

In securitisations, the link between the credit risk of the structured notes and the credit risk of the sponsor and any other counterparty to the transaction varies depending on the setup of the structures. However, the aim of securitisation is to minimise the link between the sponsor and the credit risk of the pool.

CBs maintain a link to the credit risk of the issuer/sponsor. The issuer/sponsor is the debtor of first recourse and holds influence over the quality of the cover pool, changing origination and servicing practices and the level of OC by issuing or retiring CBs and by adding or reducing the size of the cover pool.

Combining the Two

Recent political focus on the funding of SMEs has brought up proposed structures that could combine characteristics of both products. Recently, the European Covered Bond Council put together a proposal for a product, called a European Secured Note (ESN). There are currently two proposed structures for these new notes. The first structure is called an On-Balance Sheet ESN. It is dual-recourse in nature and would behave similarly to a CB. A second structure called a Risk Sharing ESN would behave much more like securitisation but with a dual-recourse nature. This could potentially create both risk transfer, with the assets held in an off-balance sheet vehicle, and risk sharing, with a secondary recourse back to the originator.

Regulatory Treatment

Various regulations implemented since the onset of the financial crisis outline specific differentiation between both CBs and securitisation. On a relative basis, CBs benefit the most from these regulatory changes with a preferential risk weighting in Europe under Capital Requirement Regulations (CRR), lower haircuts and higher allowances under the Liquidity Coverage Ratio (LCR) and lower required stable funding factor calculations for the Net Stable Funding Ratio (NSFR) for banks, as well as substantially lower capital charges under Solvency II for insurers. CBs are also highlighted as bail-in exempt under a BRRD bail-in scenario, bringing CBs on par with securitisation by diminishing the ‘bankruptcy remoteness’ appeal of securitisation. Plus, current significant risk transfer guidance from the European Banking Authority (EBA) further diminishes the comparative appeal of securitisation for capital relief purposes.

In contrast to CBs, securitisation receives a higher degree of caution from regulatory reform, particularly within Europe, with higher relative risk weights and capital charges. Also, additional requirements for securitisation investment have been implemented under the Alternative Investment Fund Managers Directive (AIFMD) and the Markets in Financial Instruments Directive (MiFID) (e.g., risk retention and due diligence requirements). However, some changes are expected with the introduction of a Simple, Transparent and Standardised (STS) definition of securitisations that is under proposal by the European Commission.

Capital Requirement Regulation

Basel III regulations from the Basel Committee on Banking Supervision outline requirements for holding capital against assets held on balance sheet. Within Europe, legislation in the form of CRR includes for CBs two main approaches to calculating the required level of capital: the Standardised Approach (SA) and the Internal Risk Based Approach (IRB). According to proposed changes to the securitisation (Basel and CRR) framework for securitisations, there will likely be three approaches: the Internal Risk Based Approach (IRBA), the External Ratings Based Approach (ERBA) and the Securitisation Standardised Approach (SEC-SA). Unlike the CB SA, the SEC-SA is not based on external risk assessments; the securitisation equivalent to CB SA is ERBA. Using the SA, CB risk weights range from 10% for Credit Quality Step 1 to 100% for Step 6. For securitisation senior tranches, using the ERBA, risk weights range from 10% for Step 1 to 210 to 355% for Step 5 and 395% to 1250% for Step 6. These levels are for qualifying securitisations, which once implemented would be for the STS framework securitisations, for non-qualifying, the weights would be even higher, particularly for subordinated notes. Using the securitisation IRBA approach with rated exposures, this can be lowered, and for some asset classes the SEC-SA would result in lower risk weights than ERBA.. In contrast, risks weights using IRB for CBs range from 2%–7% for the highest-rated CBs, to 45%–60% for lower-rated CBs, substantially less than for securitisation senior classes using any of the proposal approaches.

Liquidity Coverage Ratio

Within banking regulations, banks are required to hold a portion of their assets in liquid form in order to meet cash outflow requirements. Recent regulatory changes under Basel III, which were implemented in Europe in the form of CRR, set out the types of instruments that should be held and the haircuts associated with holding them. Recent regulatory changes under Basel III set out the types of instruments that should be held and the haircuts associated with holding them. Different types of securities and their ratings put them under different categories. In CCR, for example, cash and government bonds are considered Level 1 High Quality Liquid Assets (HQLA) with 0% haircut for calculating the LCR. CBs, for the most part, are deemed to be highly liquid instruments with a variation from Level 1 to Level 2B. To qualify for Level 1, the CB must be; issued by an issuer from the European Economic Area (EEA), be Credit Quality (CQ) Step 1 (AA (low) or higher) based on a second-best rating approach, be at least EUR 500 million outstanding and have OC of at least 2%. CBs under Level 2A include those with ratings to CQ Step 2 (A (low) or better), an issue size of EUR 250 million and OC of 7%. Also included in Level 2A are non-EEA CBs (such as Canada) that meet Level 1 requirements. Level 1 CBs will receive a haircut of 7%, and Level 2A, 15%.

Securitisations with residential mortgages, autos, consumer loans and SME loans qualify as a Level 2B HQLA. These are subject to varying haircuts ranging from 25% to 35%, depending upon their rating and underlying asset type. For example, AA low or higher-rated senior auto and RMBS tranches would have a haircut of 25%, while consumer and SME transactions would have a minimum haircut of 35%. CBs under Level 2B are haircut 30% and include EEA CBs that do not meet Level 1 and 2A rating requirements (below A (low) for EEA, and AA (low) for non-EEA CBs).

Net Stable Funding Ratio

A further level of banking regulation that is due to come into force in 2018 is the need for a bank to maintain a minimum 100% Net Stable Funding Ratio (NSFR) for its assets/investments. The percentage is calculated as available stable funding relative to the amount of required stable funding. In order to calculate the available funding, bank liability positions are assigned an available stable funding factor (ASF). Depending on the asset type, maturity, encumbrance, etc., they are graded by the extent of stable funding they provide. Bank asset positions are then assigned a required stable funding factor (RSF) and graded by the extent of stable funding they require. From the bank's viewpoint as an issuer/sponsor of CB or securitisation, both instruments are treated the same and treated as providing 100% stable funding in most cases (depending on remaining time to maturity). For securitisation, an issuer/sponsor could achieve balance-sheet deconsolidation. In this scenario, the NSFR does not apply to the securitised assets, considering the term-matching nature of securitisation. Deconsolidated securitisations transaction do not count against the leverage ratio. For a bank acting as an investor, CBs and securitisation are again treated differently. Any investment by the bank will be assigned an RSF. If this RSF is 100%, then the investment must be fully backed by stable funding. If it is 50%, it would require stable funding of half of the investment.

Investments held on a bank's balance sheet will be classified according to the LCR classifications above. CBs (unencumbered) that fit into the LCR Level 1 category will have a required stable funding of 5%, Level 2A CBs will have a RSF of 15% and 50% for Level 2B. For securitisation, Level 2B assets types (RMBS, SMEs, consumer loans and autos) with high ratings are assigned an RSF of 50%, all others are set an RSF of 85%.

Solvency II

Regulatory changes for the insurance industry were recently implemented in January 2016 under Solvency II. Within these regulations, adjustments were made to the insurer’s capital requirements for instruments held. The basis for the calculation of capital charges under Solvency II is determined using several aspects ranging from pricing volatility to concentration and illiquidity. In the Solvency 2 SA, CBs are treated relatively well, with capital charges ranging from 0.7% for a AAA-rated CB with only one-year maturity to 44% for a below-investment-grade bond with 15 years’ duration. For securitisation, SA capital charges are defined into different types, with senior bonds of transactions backed by certain residential mortgages, auto loans, SME loans and consumer credit falling under Type 1, and all other types of securitisation collateral falling under Type 2. Type 1 securitisations have a capital charge ranging from 2.1% for a AAA-rated senior tranche with a one-year maturity to 45% for a BBB-rated senior tranche with a 15-year duration.

Overall, the two products are different ways of funding and capitalising real economy assets in the capital markets. For investors, they offer a way to gain exposure to high-quality collateral and a choice in the way they choose to invest in the collateral.

	Securitisation	Covered Bonds
Issuer	The notes are issued by a bankruptcy-remote SPV, separate from the originator or servicer of the pool of assets.	Financial institution or subsidiary of a banking group.
Recourse	Limited to cash flows generated by the pool of assets (including hedging contracts, where applicable) and cash held in reserve funds.	Dual and sequential to the issuer/sponsor first and then to the cover pool. Unsecured recourse to the bankruptcy estate of the issuer.
Debt Structure	Notes are issued at inception (with the exception of master trusts). Tranches have different seniority, depending on priority of payment. Generally pass-through structures. Mainly floating-rate coupon.	Periodical issuances and taps. All series rank pari passu. Bullet maturities. Mainly fixed coupon. Sequential redemption with early maturing CBs paid first.
Credit Enhancement (CE)	CE includes OC, subordination and other features. Time subordination is occasionally used. CE is determined at inception and increases or remains unchanged as the structure de-levers. It may decrease in certain circumstances.	OC is the main form of credit enhancement. Sponsors can change OC by modifying the cover pool size or by issuing or retiring CBs. Legislation normally defines a minimum required level of OC, which is at a minimum of zero on a nominal or NPV basis.
Link to the originator/sponsor	Varies depending on structural features, though the aim is to minimize any link.	There is an ongoing and residual link to the issuer/sponsor.
Ongoing obligation of the originator/sponsor	After the transfer of assets, the originator has no ongoing responsibility over the assets other than as a potential servicer.	The issuer/sponsor is obligated to maintain quality and consistency of the cover pool to satisfy the claims of covered bond investors.
Credit Risk Transfer	Credit Risk is transferred to investors at inception. Sponsors are now required to retain an interest in the transaction due to recent regulation.	Credit Risk is transferred to investors only after the issuer defaults. Credit risk lies with the issuer, enhanced by the security of a collateral pool.
Asset Pool	<p><i>Static</i> Static pool of assets, although some modifications are allowed as outlined in the structural setup.</p> <p><i>Revolving Pool</i> Eligibility criteria set in documentation. Performance triggers in place to stop revolving.</p>	<p><i>Dynamic Cover Pool</i> The cover pool evolves over time, with minimum quality criteria set by law. Amortisation test to limit the risk of time subordination.</p>
Supervision	In some legal frameworks, securitisations are under regulator supervision.	CBs are under the supervision of the regulator. Moreover, the credit institutions’ obligations are supervised by public or other independent bodies. Almost all jurisdictions embed a cover pool monitor.

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