

# New covered bond framework based on minimum harmonization principle

## Background

On December 20 2016 the European Banking Authority (**EBA**) published a report on covered bonds, following up on its July 2014 report. Where the 2014 report identified a series of best practices with a view to ensuring robust and consistent covered bond frameworks in the European Union, the 2016 report goes further, proposing a three-step approach to the harmonization of covered bond frameworks in the European Union. The covered bond framework currently relies on principle-based EU regulation to address the key technical issues of regulatory treatment of covered bonds, leaving the implementation of such core elements at an individual member-state level and thus allowing for the diversity to arise between national laws. The harmonization of the EU covered bond framework forms part of the Capital Markets Union (**CMU**) project, an initiative of the European Commission. To assess the merits of a possible integrated EU covered bond framework, the European Commission published a consultation paper on EU covered bonds in September 2015. The 2016 report provides recommendations which the European Commission will take into consideration in the process of furthering the CMU project.

This update summarizes the EBA's three-step plan to a harmonized covered bond framework in the European Union, as set out in the 2016 report, and comments on the likely impact of such a proposal on EU covered bonds.

## Diversity in existing national covered bond frameworks

The 2016 report summarizes the results of the EBA's assessment of the functioning of – and developments in – national covered bond frameworks, which was conducted pursuant to the 2012 Recommendations

of the European Systemic Risk Board on funding of credit institutions.<sup>(1)</sup> The assessment included a comprehensive analysis of the regulatory developments in EU member states and considered the alignment of national frameworks with the EBA's best practices laid down in the 2014 report, as well as providing an analysis of market trends and EU-wide developments.

The assessment covered 22 EU member states, including those with the most active covered bond markets, such as Germany and France. The EBA's analysis shows that the best practices in the 2014 report are somewhat devoid of substance. Only 10 jurisdictions have amended their covered bond frameworks since publication of the 2014 report. The remaining 12 jurisdictions have taken no action to amend their covered bond frameworks or actions to implement the best practices has been put on hold, pending completion of the European Commission's review of the EU covered bond framework.

Active covered bond markets exist in almost all EU countries. In the 2016 report, the EBA concludes that while most national frameworks adhere to the same core principles (eg, dual recourse and coverage principles), there is also substantial diversity among the legal, regulatory and supervisory covered bond frameworks across the EU member states. This diversity is due to, among other things:

- the different systems of law applied by the relevant EU countries;
- the different approaches taken in formulating national covered bond laws; and
- the different structures of covered bond programs applied for regulatory, civil law or insolvency law reasons, or otherwise.

Such diversity does not contribute to maintaining a well-functioning EU covered bond market, which

is important given that covered bonds are seen as a key funding instrument of the EU economy.

### Favorable regulatory recognition

The 2016 report highlights the continued trend for a favorable regulatory recognition of covered bonds. Favorable regulatory recognition of covered bonds is evidenced by the following measures, among others:

- In September 2014 the European Central Bank announced the launch of the third covered bond purchase program causing an increased share of central banks' investments in covered bonds.
- Covered bonds are included as a liquidity buffer (level 1 and level 2A assets) under the EU liquidity coverage ratio, incentivizing credit institutions to invest in covered bonds.
- The EU banking recovery and resolution framework exempts covered bonds from the scope of the bail-in instrument, making them the only wholesale funding instrument exempt from bail-in.

However, the 2016 report also concludes that covered bond instruments with different quality characteristics are subject to the same EU regulatory rules and, therefore, all benefit from such far-reaching favorable regulatory recognition, irrespective of the EU member state in which they are issued.

The EBA's aim in proposing a harmonized EU covered bond framework is to ensure that only those financial instruments that are compliant with the requirements set out in the framework could qualify as 'covered bonds' and thereby benefit from the preferential prudential and risk-weight treatment for EU covered bonds in the mid-to-long term.

### Three steps to a harmonized covered bond framework

The 2016 report contains a detailed proposal for a three-step approach to the harmonization of covered bond frameworks in the European Union. The EBA attempts to ensure more consistency in the definition and regulatory treatment of EU covered bonds, while building on the strengths of the existing national covered bond frameworks and maintaining the flexibility and specificities of such frameworks. The three-step approach consists of:

- an EU Covered Bonds Directive;
- amendments to the EU Capital Requirements Regulation (575/2013); and
- a voluntary convergence.

#### Step 1: EU Covered Bonds Directive

EU covered bond regulation is laid down in several directives and regulations, of which the most important are considered to be:

- Article 52(4) of the Undertakings for Collective Investment in Transferable Securities Directive (2009/65/EC); and
- Article 129 of the Capital Requirements Regulation.

The Undertakings for Collective Investment in Transferable Securities (**UCITS**) Directive defines the core characteristics of covered bond instruments and the Capital Requirements Regulation (**CRR**) sets out preferential risk-weight treatment for covered bonds, as referred to in the directive, which meet specified conditions. Other EU legislation sets out specific treatment for covered bonds compliant with either the UCITS Directive or the CRR.

The EBA recommends developing an EU covered bond framework through the implementation of an EU Covered Bonds Directive. The proposed directive would apply across different financial sectors and be based on the minimum harmonization principle.

The EBA also recommends that the covered bond framework establish a definition of the term ‘covered bond’ that will serve as a baseline for prudential regulation purposes. Reference to the definition of ‘covered bond’ in the EU Covered Bonds Directive should be used in all EU regulations that include specific treatments for covered bonds.

The EBA further recommends that the covered bond framework replace the existing principle-based provisions in the UCITS Directive with a more detailed set of existing and additional requirements, applicable to all EU covered bonds and covering a wide range of areas necessary to preserve the covered bond brand.

The areas that should be covered in a proposed EU covered bond framework are:

- the dual recourse of a covered bond, segregation of cover assets and bankruptcy remoteness of a covered bond;
- the coverage principle, liquidity risk mitigation and cover pool derivatives;
- a system of special public supervision and administration; and
- transparency and disclosure.

### Step 2: amendments to Capital Requirements Regulation

Step 2 is closely related to Step 1 of the proposed three-step approach. However, it relates to preferential capital treatment, focusing on specific amendments to provisions of the CRR. Covered bonds that meet

the definition of ‘covered bond’ as formulated in the covered bond framework (Step 1 above) are not automatically eligible for preferential risk-weight treatment. As under the current applicable rules, the additional criteria for eligibility for preferential risk-weight treatment will be set out in the CRR. In addition to the existing provisions, new conditions for access to preferential risk-weight treatment of investments in covered bonds will be included. The EBA considers that the CRR should clarify that only covered bonds meeting the requirements stated in both the proposed EU Covered Bonds Directive and the amended CRR will be eligible for preferential risk-weight treatment.

In addition to the requirements under Step 1’s proposed covered bond framework, the areas that should be covered under Step 2 include, among other things:

- requirements for eligible cover assets and loan-to-value limits for mortgage cover assets, and limits on substitution assets;
- requirements for minimum over-collateralization.

With respect to the requirements for eligible cover assets, the EBA recommends that the scope of covered assets not be widened and that small and medium-sized enterprise loans, infrastructure loans and additional non-public debtor loans are excluded as eligible cover assets for such preferential treatment. The EBA suggests that the eligibility of shipping loans should be considered further before determining their treatment.

### Step 3: voluntary convergence

Step 3 covers areas that have less material impact on the protection of quality of the covered bond product and areas where convergence is considered beneficial, but where (binding) minimum harmonization could have disruptive effects on national covered bond markets.



The EBA considers that convergence between national frameworks should be emboldened on a voluntary basis through non-binding instruments. According to the EBA, such non-binding measures should provide for additional rules on, among other things:

- the composition of cover pools;
- the treatment of cover pools with assets or obligors located in non-EEA jurisdictions;
- asset valuation and monitoring (eg, loan-to-value thresholds); and
- stress testing in relation to the coverage requirement.

In the 2016 report, the EBA suggests that voluntary convergence issues are secondary to the measures proposed in Steps 1 and 2 above. It therefore recommends that non-compliance with these recommendations should not affect the eligibility of a covered bond for preferential regulatory or risk-weight treatment.

### Key considerations

The EBA's three-step approach makes sense in an attempt to harmonize covered bond frameworks across the European Union. Given the diversity of the existing legal, regulatory and supervisory covered bond frameworks, and the strength of existing national covered bond frameworks, a minimum harmonization measure is probably the most realistic method of creating effective harmonization that defines and preserves a quality covered bond product for EU financial regulation purposes and justifies a preferential prudential and risk-weight treatment for EU covered bonds.

It should be relatively straightforward for most EU member states to implement a number of the EBA's recommendations at a national level (if this has not already been done). However, some recommendations – as acknowledged by the EBA – require careful

consideration before they become detailed legislative requirements, in order to preserve well-functioning markets, existing legal structures of covered bond programs and the economic rationale of using covered bonds as a funding tool.

At a broader level, it is worth considering the potential interaction between the proposed EU covered bond framework legislation and other existing EU legislation, such as the European resolution and recovery framework established under the Bank Recovery and Resolution Directive (2014/59/EU) (**BRRD**) and the Single Resolution Mechanism Regulation (806/2014). Further analysis is required to avoid uncertainty, at both an EU and national level. This issue is relevant to the proposed EU covered bond framework in terms of:

- step 1 – the system of special public supervision and administration relating to covered bonds in the event of an issuer’s resolution or insolvency; and
- steps 1 and 2 – coverage requirements and minimum over-collateralization.

#### Step 1: system of special public supervision and administration in the event of resolution or insolvency

An untested area remains between the interactions between:

- the duties of the competent authority and the independent special administrator responsible for supervision and administration (respectively) of cover pools and covered bonds of an issuer in resolution;
- the duties and rights of the resolution authority relating to resolution tools provided under the Bank Recovery and Resolution Directive and, where applicable, the Single Resolution Mechanism Regulation.

The same concern applies in the event of an issuer’s insolvency and a receiver or administrator’s appointment.

The scope of duties and responsibilities should be clearly defined to ensure that the cover pool can be managed in the interest of the covered bondholders without at the same time affecting the tools and rights available to the resolution authority under the Bank Recovery and Resolution Directive and the Single Resolution Mechanism Regulation, but without prejudice to the protected position of covered bonds under such legislation. The scope of duties and responsibilities of the competent authority should also be sufficiently clear to avoid conflicts of interest in its functions as supervisor of the covered bonds and regulator of the issuer credit institution, both in going-concern and gone-concern situations. Further, detailed analysis will be required to address asset encumbrance issues and to strike a balance between the interests of the covered bondholders and those of unsecured creditors of the issuer credit institution.

#### Steps 1 and 2: coverage requirements and minimum over-collateralization

The EBA’s recommendations include proposals for:

- the calculation of cover assets;
- eligibility criteria applicable to cover assets;
- minimum over-collateralization requirements to ensure that there is sufficient coverage for the covered bonds and related liabilities.

Pursuant to Article 27(3)(b) of the Single Resolution Mechanism Regulation and Article 44(2)(b) of the BRRD, covered bonds are excluded from the applicability of the write-down and conversion powers laid down in the BRRD and the Single Resolution Mechanism Regulation. This means, in principle, that covered bonds cannot be written down following a bail-in intervention by the relevant resolution authority in relation to an issuer. However, such write-down powers can be used in cases where the liabilities from

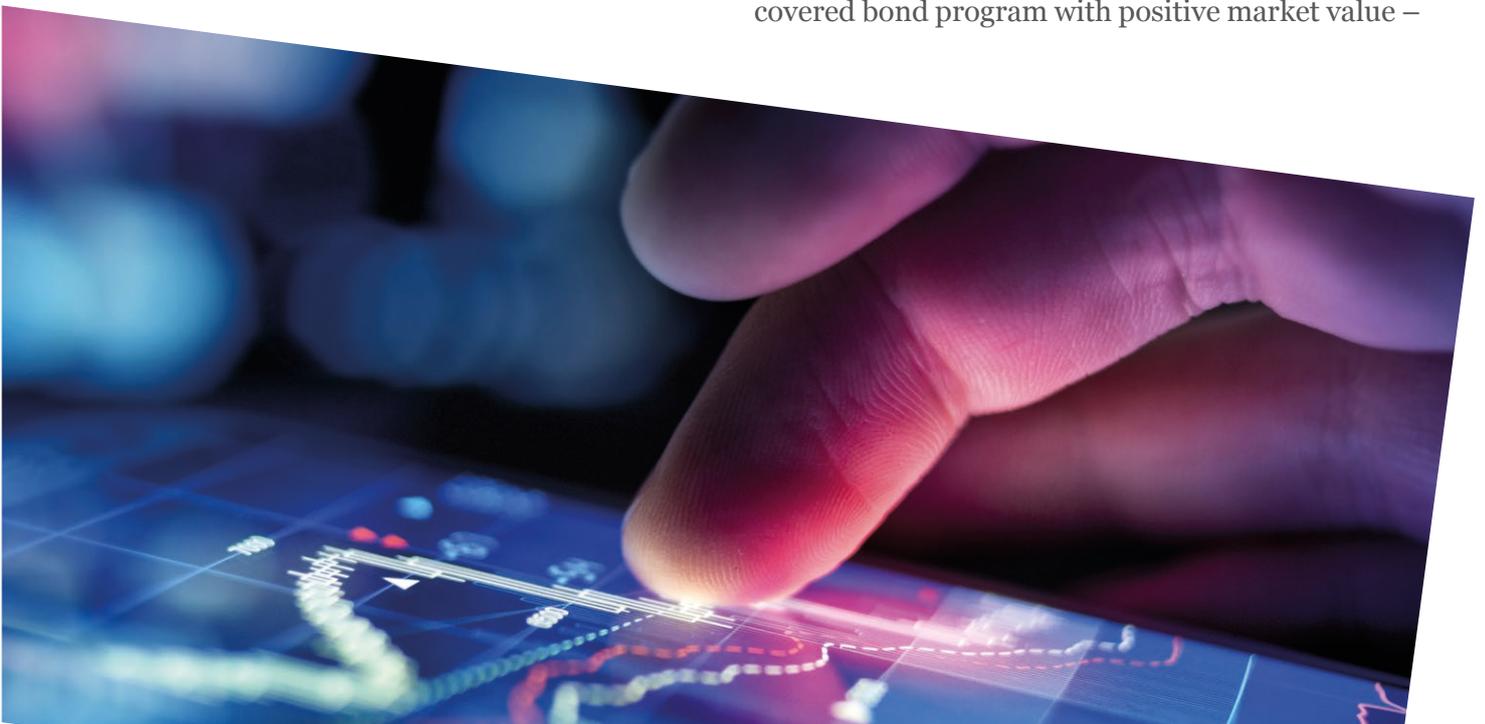
the covered bonds exceed the collateral. It is unclear how and when, during any such bail-in intervention, the value of such collateral is determined and how voluntary over-collateralization is treated. This could affect the preferential interests of covered bondholders. It would be sensible for the EU resolution legislation to clarify this issue and other points relating to safeguards available for covered bonds under the resolution framework (e.g., in the context of a partial transfer of assets and liabilities as a resolution tool).

In addition, without purporting to be complete, it is understood that in determining whether the cover assets provide sufficient coverage to pay all liabilities of, or related to, the covered bonds (ie, the coverage requirement is complied with), the value of cover pool derivatives as a component of such cover assets (expressed as a positive or negative amount) must be taken into account. Such value is determined by:

- calculating the cash in and outflows under all cover pool derivatives entered into under a market-standard master derivatives agreement (e.g., International Swaps and Derivatives Association) on an aggregate basis – a so-called ‘aggregate cash-flow amount’;
- comparing such amount with the close-out amount determined under such master agreement in respect of such derivatives.

The smaller amount will be taken into account as a component (expressed as a positive or negative amount) for determining the value of the cover pool assets.

In the current low-interest climate, determining the value of cover pool derivatives for the purpose of calculating the cover pool assets as part of the coverage requirement could negatively impact covered bond structures in EU jurisdictions which use ‘basis swap’ or ‘total return swap’ derivatives (e.g., under which the rate of interest received on the primary assets is swapped for a basis reference rate) to mitigate interest rate risk between the cover pool assets and covered bonds, if the negative market value of such derivatives – even if determined on a net basis, taking into account other cover pool derivatives for the same covered bond program with positive market value –



exceeds the aggregate cash-flow amount referred to above. This could be particularly relevant to structures with high over-collateralization. The EBA's proposed recommendation could be expanded on to clarify the process of determining the value of cover pool derivatives as part of the coverage requirement.

Finally, it remains to be seen how requirements are actually implemented in the EU covered bond framework to preserve the strength of the covered bond brand, and how much flexibility will be created to cater for innovative covered bond structures such as (conditional) pass-through covered bonds with long maturity extension options.

### Grandfathering

Following the 2016 report, the EBA recommends that existing covered bonds issued before the new EU covered bond framework's entry into force and benefiting from the existing preferential (risk weight) treatment not be affected by the new framework, and thus continue to benefit from such preferential treatment until their maturity.

### Next steps

Following publication of its consultation paper on EU covered bonds in September 2015, the European Commission recently announced that – as part of its CMU mid-term review – it will set out which legislative changes may be needed to support the development of EU covered bond markets. The European Commission will likely take account of the recommendations contained in the EBA's 2016 report when finalizing its proposals, and has announced that it intends to complete the CMU mid-term review in June 2017.

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