

CBIC position on European legislation on covered bonds – April 2018

Introduction

On 12 March 2018 the European Commission launched their long-awaited [legislative proposal on covered bonds](#), in the form of a [directive on covered bonds](#) and a [regulation amending the treatment of covered bond exposures under the CRR](#).

The ICMA Asset Management and Investor Council's (AMIC) Covered Bond Investor Council (CBIC) has followed the progress of the European Commission's deliberations with interest. On 5 January 2016 CBIC [responded](#) to the Commission's consultation on covered bonds as preparation for this legislative initiative.

This paper forms an initial analysis of the legislation and offers some targeted suggestions for improvements.

General comments

The Covered Bonds Investor Council (CBIC) welcomes the European Commission's legislation on covered bonds. Although we may have expressed some concern in the past regarding the need for this legislation, the extensive preparatory work by the European Banking Authority (EBA) ([the 2016 report on covered bonds](#)) and the Commission ([consultation](#), [impact assessment](#)) has laid the ground for a sensible proposal that should achieve the objectives sought.

In particular, investors appreciate that the high-level framework directive will provide an easy to use blueprint for those countries that do not yet have a covered bond law to introduce one.

Also, the CBIC welcomes the overcollateralisation (OC) regime introduced in the regulation amending the CRR. The minimum 5% level is welcome, as it should prevent potential issuance below that level.

Investors are pleased that in many of the areas that national traditions have developed a robust national covered bond framework are allowed to exist within this European framework. This flexibility should minimise disruption to well-functioning national covered bond frameworks that are relied on by issuers and investors. However, this flexibility is in some areas of the text taken too far and risks lowering standards.

We will develop some of these thoughts in our detailed comments below. In several cases, we believe the EBA could play a useful report in providing helpful guidance to market participants and to countries developing or updating their covered bond frameworks.

Detailed comments

Assets in the cover pool

In trying to allow sufficient flexibility for existing national frameworks, the directive is too imprecise with the definition of eligible assets in Article 6. While defining eligible assets as those allowed by

Article 129 of the Capital Requirements Regulation (CRR), the directive also allows “other high quality assets” that have to meet certain legal requirements set out in four points (Article 6(1)(a)-(d)). Recital (15) also allows loans to public undertakings as defined in Article 2(b) of Commission Directive 2006/111/EC. We find it incongruous that this specific reference to loans to public undertakings is included in the Recital but not in the relevant Article on eligible assets.

While we agree that it is not unwarranted to set some basic principles for what “other high quality assets” could mean, in order not to permanently limit eligible assets to Article 129 assets, the criteria set out in Article 6 are useful but not sufficient for investors who need certainty on the high quality of the eligible assets in the cover pool.

CBIC therefore suggests that the legislation is amended to allow the EBA a role in giving clarity about what the “other high quality assets” could mean. We believe that empowering the EBA to draft guidance on high quality assets other than Article 129 assets, and reviewing that guidance every five years, would help investor certainty about the quality of European covered bonds. Such guidance could, for instance, include specific reference to the loans to public undertakings if the EBA decided to include them in the list of “other high quality assets”.

Similarly, Article 10 allows Member States to define what “sufficient level of homogeneity” should mean for assets in the cover pool. In order to prevent cover pools where the national definitions of “homogeneity” are too loose, the EBA should be given a role in giving guidance on some minimum standards.

The EBA is already creating criteria for homogenous assets for simple, transparent and standardised (STS) securitisations, so there is already some historical work that can be used as the basis for guidance.

Transparency

We understand and support the principles based approach of the directive. However, in allowing so much flexibility to Member States, investors are concerned that standards could fall lower than what they are currently. Investors have worked with issuers for many years to create a Harmonised Transparency Template (HTT), provided by the European Covered Bond Council (ECBC) in the use of their Covered Bond Label. Investors appreciate the HTT as a useful disclosure

Therefore, while retaining the principles based approach in the directive is fine, we believe there is scope to refer to industry initiatives in the recitals to keep the HTT in mind as high standard of transparency that investors appreciate.

Third countries

CBIC welcomes the intention by the Commission in the legislation to submit a report on an equivalence regime that could be introduced for third country covered bond frameworks. However, three years is too long a time period for a report to be submitted. Any practical equivalence steps would take much longer time still. Meanwhile, investors would not be able to achieve capital benefit from investing in third country covered bonds even if the regime is equivalent to the European one.

Therefore, we would propose to reduce the amount of time before the report on equivalence is submitted to two years instead of three to allow a swifter implementation of equivalence regimes for third countries. The EBA should also start the process by submitting a report to the Commission one year after application to help design the technical framework for equivalence assessments.

We understand that it is impossible to introduce hard rules on third party equivalence whilst the Brexit negotiations are on-going but would prefer that the EBA start to consider this topic with regard to existing third-party regimes sooner rather than later and certainly before the three year deadline referred to in the current text.

Our members would benefit from the ability to diversify their investments better if an appropriate alignment of risk and prudential treatment was available for third country frameworks.

Extendable maturity structures

CBIC welcomes the criteria in Article 17 for the use of extendable maturities. We do not object to extendable maturities but are concerned that their use should be more strictly controlled to prevent abuse.

To this end, we are concerned that the event of default of the issuer is not in itself a trigger in Article 17, even though the EBA suggested this as a condition to extendable maturity covered bonds on page 137 of their 2016 report. We consider that the current wording, that states that the trigger should not be 'at the discretion of the issuer', is too weak without the introduction of a trigger in the event of default, in the form of the insolvency of the issuer.

Cover pool liquidity buffer

CBIC welcomes the broad transposition of current best practice and EBA recommendations for liquidity pool buffers in Article 16. However, given the important framework this legislation will set for European covered bonds, we believe it is worth specifying in slightly greater detail what some of the liquidity pool concepts could mean.

Specifically, we believe it is worth giving the EBA a role in providing some guidance on how to calculate the cover pool liquidity buffer covering net liquidity outflow for 180 days in Article 16, for example, defining whether coupon payments in assets in collateral supporting derivatives should be included in the calculation.

Furthermore, we are concerned that Liquidity Coverage Ratio (LCR) buffers held outside cover pools may be used as a substitute for cover pool liquidity buffers in Article 16 paragraph 4. LCR buffers do not offer the same segregated protection to investors in covered bonds as cover pool buffers do. Therefore, we recommend reversing this to allow cover pool liquidity buffers to be used for LCR buffer purposes.

Intragroup pooled covered bonds

CBIC appreciates the need to allow for intragroup pooled covered bonds, either under existing structures in some Member States or in the future to potentially promote the asset class among more issuers.

However, the proposal is inconsistent. By requiring a CRR Credit Quality Step 1 (AA-) minimum rating for the issuer of the “internal covered bonds” in addition to the external covered bond, the proposal could limit the use of this tool in those countries where it may be most useful in countries with lower ratings. We would propose to remove the minimum rating requirement for the internal covered bond.

Cover pool monitors

CBIC believes that where cover pool monitors are used, EBA could provide guidance on the minimum criteria for the roles and duties of cover pool monitors to help provide more certainty to investors and to countries considering requiring the use of cover pool monitors.

Overcollateralisation

CBIC appreciates the importance of allowing current overcollateralisation (OC) models to exist within the new European Covered Bond label being created and supports the minimum nominal 5% OC level in the regulation. However, the directive and regulation introduce the potential for confusion by allowing various calculation methods which could result in lower nominal OC levels. The proposals are too complex and hard to grasp for a regulatory regime that wants to harmonise and make things more transparent.

We believe a clearer way to achieve harmonisation would be to allow the different methods of calculation but to not allow OC levels lower than 5% based on the nominal principle.

ENDS

Annex – Suggested CBIC amendments to directive on the issue of covered bonds and covered bond public supervision

Transparency

Recital 20

Text proposed by the Commission	Suggested amendment
<p>(20) Transparency of the cover pool securing the covered bond is an essential part of this type of financial instrument as it enhances comparability and allows investors perform the necessary risk evaluation. Directive 2003/71/EC12 of the European Parliament and of the Council includes rules on the drawing up, the approval and the distribution of the prospectus to be published when securities are offered to the public or admitted to trading on a regulated market situated or operating within a Member State. Several initiatives regarding the information to be disclosed to covered bond investors to supplement Directive 2003/71/EC have been developed over time by national legislators and market participants. It is however necessary to specify at Union level what the minimum common level of information investors should have access to prior to or when buying covered bonds. Member States should be allowed to supplement these minimum requirements with additional provisions.</p>	<p>(20) Transparency of the cover pool securing the covered bond is an essential part of this type of financial instrument as it enhances comparability and allows investors perform the necessary risk evaluation. Directive 2003/71/EC12 of the European Parliament and of the Council includes rules on the drawing up, the approval and the distribution of the prospectus to be published when securities are offered to the public or admitted to trading on a regulated market situated or operating within a Member State. Several initiatives regarding the information to be disclosed to covered bond investors to supplement Directive 2003/71/EC have been developed over time by national legislators and market participants. It is however necessary to specify at Union level what the minimum common level of information investors should have access to prior to or when buying covered bonds. Member States should be allowed to supplement these minimum requirements with additional provisions, <i>for instance by reference to transparency initiatives under existing covered bond labels in the Union.</i></p>

Eligible Assets

Article 6

Text proposed by the Commission	Suggested amendment
	<p><i>4. By 1 June 2019, EBA shall adopt, in accordance with Article 16 of Regulation (EU) No 1093/2010, guidelines and recommendations specifying the types of assets meeting the criteria for other high quality assets in paragraph 1. EBA shall review that guidance every 5 years.</i></p>

Recital (15)

Text proposed by the Commission	Suggested Amendment
<p>Another core feature of existing national covered bond frameworks is the fact that assets serving as collateral should be of very high quality in order to ensure the robustness of the cover pool. High quality assets are characterised by having specific features making them eligible to cover the claims attached to the covered bond. It is therefore appropriate to set out the general quality features that assets should respect in order to be eligible to serve as collateral. Assets listed in points (a) to (g) of Article 129(1) of Regulation (EU) No 575/2013 should be considered eligible to serve as collateral in the cover pool, within a covered bond framework, as should loans involving public undertakings as defined in Article 2(b) of Commission Directive 2006/111/EC but also other assets of a similar high quality could be considered eligible under the Directive, provided that it is possible to determine either their market value or mortgage lending value. Furthermore, the Directive should include rules to ensure that assets, including guaranteed loans, can be repossessed or called in through an enforceable protection agreement, whether in the form of a traditional mortgage or by a charge, lien or guarantee providing the same level of legal protection, and thus ensuring the same level of safety for investors. However, those provisions on the eligibility of assets should not prevent Member States from allowing other categories of assets to serve as collateral in their national frameworks provided the assets comply with Union law. Member States should also be free to exclude assets in their national frameworks.</p>	<p>Another core feature of existing national covered bond frameworks is the fact that assets serving as collateral should be of very high quality in order to ensure the robustness of the cover pool. High quality assets are characterised by having specific features making them eligible to cover the claims attached to the covered bond. It is therefore appropriate to set out the general quality features that assets should respect in order to be eligible to serve as collateral. Assets listed in points (a) to (g) of Article 129(1) of Regulation (EU) No 575/2013 should be considered eligible to serve as collateral in the cover pool, within a covered bond framework, as could other assets of a similar high quality such as loans involving public undertakings as defined in Article 2(b) of Commission Directive 2006/111/EC but also other assets of a similar high quality could be considered eligible under the Directive, provided that it is possible to determine either their market value or mortgage lending value. The EBA should provide guidance with regard to what other assets of high quality should include. Furthermore, the Directive should include rules to ensure that assets, including guaranteed loans, can be repossessed or called in through an enforceable protection agreement, whether in the form of a traditional mortgage or by a charge, lien or guarantee providing the same level of legal protection, and thus ensuring the same level of safety for investors. However, those provisions on the eligibility of assets should not prevent Member States from allowing other categories of assets to serve as collateral in their national frameworks provided the assets comply with Union law. Member States should also be free to exclude assets in their national frameworks.</p>

Intragroup pooled covered bond structures

Article 8

Text proposed by the Commission	Suggested amendment
<p>Member States may lay down rules regarding the use, by way of an intragroup transaction, of covered bonds issued by a credit institution belonging to a group ('internally issued covered bonds') as collateral for the external issue of covered bonds by another credit institution 'belonging to the same group ('externally issued covered bonds'). Member States shall ensure investor protection by including at least the following requirements in those rules:</p> <p>(a) the internally issued covered bonds, which are used as collateral for the externally issued covered bonds, are recorded on the balance sheet of the credit institution which issues the externally issued covered bonds;</p> <p>(b) the credit institution issuing the externally issued covered bond has a claim on the credit institution issuing the internally issued covered bonds, which is secured by the internally issued covered bonds;</p> <p>(c) the externally issued covered bonds are sold to covered bond investors outside the group;</p> <p>(d) both the internally and the externally issued covered bonds qualify for credit quality step 1 as referred to in Part Three, Title II, Chapter 2 of Regulation (EU) No 575/2013 and are collateralised by residential or commercial property mortgages.</p>	<p>Member States may lay down rules regarding the use, by way of an intragroup transaction, of covered bonds issued by a credit institution belonging to a group ('internally issued covered bonds') as collateral for the external issue of covered bonds by another credit institution 'belonging to the same group ('externally issued covered bonds'). Member States shall ensure investor protection by including at least the following requirements in those rules:</p> <p>(a) the internally issued covered bonds, which are used as collateral for the externally issued covered bonds, are recorded on the balance sheet of the credit institution which issues the externally issued covered bonds;</p> <p>(c) the credit institution issuing the externally issued covered bond has a claim on the credit institution issuing the internally issued covered bonds, which is secured by the internally issued covered bonds;</p> <p>(d) the externally issued covered bonds are sold to covered bond investors outside the group;</p> <p>(e) both the internally and the externally issued covered bonds qualify for credit quality step 1 as referred to in Part Three, Title II, Chapter 2 of Regulation (EU) No 575/2013 and are collateralised by residential or commercial property mortgages.</p>

Homogeneity

Article 10

Text proposed by the Commission	Suggested amendment
<p>Member States shall ensure investor protection by providing for a sufficient level of homogeneity of the assets in the cover pool so that they shall be of a similar nature in terms of</p>	<p>1. Member States shall ensure investor protection by providing for a sufficient level of homogeneity of the assets in the cover pool so that they shall be of a similar nature</p>

structural features, lifetime of assets or risk profile.	<p>in terms of structural features, lifetime of assets or risk profile.</p> <p>2. By 1 June 2019, EBA shall adopt, in accordance with Article 16 of Regulation (EU) No 1093/2010, guidelines and recommendations specifying minimum criteria for homogenous assets under paragraph 1.</p>
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Cover pool monitor

Article 13

Text proposed by the Commission	Suggested amendment
	<p>5. By 1 June 2019, EBA shall adopt, in accordance with Article 16 of Regulation (EU) No 1093/2010, guidelines and recommendations specifying minimum criteria for the role and duties of cover pool monitors under paragraph 2(c).</p>

Requirement for cover pool liquidity buffer

Article 16

Text proposed by the Commission	Suggested amendment
4. Where the credit institution issuing covered bonds is subject to liquidity requirements set out in other acts of Union law, Member States may decide that the national rules transposing paragraphs 1, 2 and 3 do not apply throughout the period foreseen in those acts of Union law.	4. Where the credit institution issuing covered bonds is subject to liquidity requirements set out in other acts of Union law, Member States may decide that the assets used for the purposes of paragraph 1 may be used to fulfil those liquidity requirements set out in acts of Union law.
	<p>7. By 1 June 2019, EBA shall adopt, in accordance with Article 16 of Regulation (EU) No 1093/2010, guidelines and recommendations specifying the types of assets that can be used for the purposes of paragraph 1. EBA shall review these guidelines and recommendations every 5 years.</p>

Conditions for extendable maturity structures

Article 17

Text proposed by the Commission	Suggested amendment

<p>1. Member States may allow for the issue of covered bonds with extendable maturity structures where investor protection is ensured by at least the following:</p> <p>(a) the maturity extension triggers are specified in contract or statute;</p> <p>(b) the maturity extension is not triggered at the discretion of the credit institution issuing covered bonds;</p> <p>(c) the information provided to the investor about the maturity structure is sufficient to enable them to determine the risk of the covered bond, and includes a detailed description of:</p> <p>(i) the maturity extensions trigger;</p> <p>(ii) the consequences for the maturity extensions in the case of insolvency or resolution of the credit institution issuing covered bonds;</p> <p>(iii) the role of the competent authority designated pursuant to Article 18(2) and of the special administrator with regard to the maturity extension, where relevant;</p> <p>(d) the final maturity date of the covered bond can at all times be determined;</p> <p>(e) the maturity extension does not affect the ranking of covered bond investors;</p> <p>(f) the maturity extension does not change the structural features of the covered bonds regarding dual recourse as referred to in Article 4 and bankruptcy remoteness as referred to in Article 5.</p>	<p>1. Member States may allow for the issue of covered bonds with extendable maturity structures where investor protection is ensured by at least the following:</p> <p>(a) the maturity extension triggers are specified in contract or statute;</p> <p>(b) the maturity extension is not triggered at the discretion of the credit institution issuing covered bonds;</p> <p>(c) The maturity extension may only be effected upon: (i) the insolvency of the credit institution issuing the covered bond; and (ii) breach of triggers defined in sub-paragraph (d)(i);</p> <p>(d) the information provided to the investor about the maturity structure is sufficient to enable them to determine the risk of the covered bond, and includes a detailed description of:</p> <p>(i) the maturity extensions trigger;</p> <p>(ii) the consequences for the maturity extensions in the case of insolvency or resolution of the credit institution issuing covered bonds;</p> <p>(iii) the role of the competent authority designated pursuant to Article 18(2) and of the special administrator with regard to the maturity extension, where relevant;</p> <p>(e) the final maturity date of the covered bond can at all times be determined;</p> <p>(f) the maturity extension does not affect the ranking of covered bond investors;</p> <p>(g) the maturity extension does not change the structural features of the covered bonds regarding dual recourse as referred to in Article 4 and bankruptcy remoteness as referred to in Article 5.</p>
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Reviews and Reports

Article 31

Text proposed by the Commission	Suggested amendment
<p>1. By XX [OP: please insert the date laid down in the second subparagraph of Article 32(1) of this Directive + 3 years], the Commission shall, in</p>	<p>1. By XX [OP: please insert the date laid down in the second subparagraph of Article 32(1) of this Directive + 2 years], the Commission shall, in</p>

<p>close cooperation with EBA, submit a report to the European Parliament and to the Council whether an equivalence regime could be introduced for third-country credit institutions issuing covered bonds and for investors in covered bonds, taking into consideration international developments in the area of covered bonds, in particular the development of legislative frameworks in third countries.</p>	<p>close cooperation with EBA, submit a report to the European Parliament and to the Council whether an equivalence regime could be introduced for third-country credit institutions issuing covered bonds and for investors in covered bonds, taking into consideration international developments in the area of covered bonds, in particular the development of legislative frameworks in third countries. By XX [OP: please insert date laid down in the second subparagraph of Article 32(1) of this Directive + 1 year] the EBA should submit a report to the Commission to establish a technical framework for third country equivalence assessment.</p>
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Recital (35)

Text proposed by the Commission	Suggested amendment
<p>There is currently no equivalence regime for the recognition of covered bonds issued by credit institutions in third countries by the Union except in a prudential context where preferential treatment regarding liquidity is granted to some third-country bonds under certain conditions. The Commission should therefore in close cooperation with EBA assess the need and relevance for an equivalence regime to be introduced for third-country issuers of and investors in covered bonds. The Commission should, no more than 3 years after the date from which Member States are to apply the provisions transposing this Directive, submit a report to the European Parliament and to the Council, together with a legislative proposal, if appropriate, on this issue.</p>	<p>There is currently no equivalence regime for the recognition of covered bonds issued by credit institutions in third countries by the Union except in a prudential context where preferential treatment regarding liquidity is granted to some third-country bonds under certain conditions. The Commission should therefore in close cooperation with EBA assess the need and relevance for an equivalence regime to be introduced for third-country issuers of and investors in covered bonds. The Commission should, no more than 2 years after the date from which Member States are to apply the provisions transposing this Directive, submit a report to the European Parliament and to the Council, together with a legislative proposal, if appropriate, on this issue. To assist the Commission, the EBA should submit a report to the Commission no more than 1 year after the date from which Member States are to apply the provisions transposing this Directive.</p>

Suggested CBIC amendment to proposal for a regulation of the European Parliament and of the Council amending Regulation (EU) No 575/2013 as regards exposures in the form of covered bonds

Article 1

Text proposed by the Commission	Suggested amendment
<p>"3a. In addition to being collateralised by the eligible assets listed in paragraph 1, covered bonds shall be subject to a minimum level of 5 % of overcollateralisation as defined in Article 3(12) of Directive (EU) 20xx/xxx [OP: Please insert reference to Directive (EU) on the issue of covered bonds and covered bond public supervision and amending Directive 2009/65/EC and Directive 2014/59/EU].</p> <p>For the purposes of the first subparagraph, the total nominal amount of all assets in the cover pool shall be at least of the same value as the total nominal amount of outstanding covered bonds ('nominal principle') and consist of eligible assets as set out in paragraph 1.</p> <p>The assets contributing to a minimum level of overcollateralisation shall not be subject to the limits on exposure size as set out in points (b) and (c) of the first subparagraph of paragraph 1 and shall not count towards those limits.</p> <p>Competent authorities designated pursuant to Article 18(2) of Directive (EU) 20xx/xxx [OP: Please insert reference to Directive (EU) on the issue of covered bonds and covered bond public supervision and amending Directive 2009/65/EC and Directive 2014/59/EU] may decide to apply a lower minimum level of overcollateralisation to covered bonds provided that the following conditions are met:</p> <p>(a) the calculation of overcollateralisation is either based on a model which takes into account the assigned risk weights of the assets or a model where the valuation of the assets is subject to mortgage lending value as defined in Article 4(1)(74);</p>	<p>"3a. In addition to being collateralised by the eligible assets listed in paragraph 1, covered bonds shall be subject to a minimum level of 5 % of overcollateralisation as defined in Article 3(12) of Directive (EU) 20xx/xxx [OP: Please insert reference to Directive (EU) on the issue of covered bonds and covered bond public supervision and amending Directive 2009/65/EC and Directive 2014/59/EU].</p> <p>For the purposes of the first subparagraph, the total nominal amount of all assets in the cover pool shall be at least of the same value as the total nominal amount of outstanding covered bonds ('nominal principle') and consist of eligible assets as set out in paragraph 1.</p> <p>The assets contributing to a minimum level of overcollateralisation shall not be subject to the limits on exposure size as set out in points (b) and (c) of the first subparagraph of paragraph 1 and shall not count towards those limits.</p> <p>Competent authorities designated pursuant to Article 18(2) of Directive (EU) 20xx/xxx [OP: Please insert reference to Directive (EU) on the issue of covered bonds and covered bond public supervision and amending Directive 2009/65/EC and Directive 2014/59/EU] may decide to apply a lower minimum level of overcollateralisation to covered bonds provided that the following conditions are met:</p> <p>(a) the calculation of overcollateralisation is either based on a model which takes into account the assigned risk weights of the assets or a model where the valuation of the assets is subject to mortgage lending value as defined in Article 4(1)(74);</p>

(b) the minimum level of overcollateralisation cannot be lower than 2 % based on the nominal principle.

(b) the minimum level of overcollateralisation cannot be lower than **2 5** % based on the nominal principle.