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Draft Directive of the European Commission on Covered Bonds

On 12 March 2018, the European Commission presented the long-awaited "Proposal for a directive on the issue of covered bonds and covered bond public supervision and amending Directive 2009/65/EC and Directive 2014/59/EU". In parallel to this, an amendment of Article 129 CRR was also proposed, complementing the requirements on the preferential risk weighting of covered bonds. The two proposals are part of the package of measures designed to complete the Capital Markets Union.

This initiative seeks to strengthen the European covered bond markets by laying down binding structural features and definitions. This also applies to Member States in which covered bonds are hardly used or not used at all. At the same time, the aim is to lay the groundwork for safeguarding the existing preferential regulatory treatment of Pfandbriefe and comparable covered bonds in the EU going forward.

The draft directive is principles-based and so guarantees that sufficient scope will be given for traditions and specificities of the individual national covered bond regimes. Thus, well-functioning covered bond markets would not be hampered as a result and could continue to focus on what they do best. We welcome this approach, one which we called for very early on when the regulatory considerations first got under way.

Principles-based does not mean short on content. On the contrary, the proposal defines a complete legal framework for covered bonds that appears to be well structured and covers all the core elements that are necessary for covered bonds in the EU to be of high quality and safe. Especially welcome in this context is the design of covered bond public supervision, which is likely to give a considerable boost to the supervisory practices currently in place in a number of Member States and therefore to further strengthen investor confidence in this asset class.

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Specifically, the proposal addresses all the features that are covered by the definition of a covered bond as set out in Article 52 (4) UCITS Directive.* It makes sense that this provision is supposed to be replaced by the directive.

* Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS)

Cover assets

Only rough parameters are given for assets that are eligible as cover. There is no exhaustive list nor are specific terms provided. This could lead to uncertainties with regard to quality. According to Article 6 of the draft, high-quality and collateralized assets are required. Although certain quality-related requirements are inferred by the criteria set out in this provision (assessibility, enforceability, legal certainty) and by the reference to the cover assets eligible for preferential treatment pursuant to Article 129 CRR, it is ultimately left to Member States to make the decision concerning the eligibility of assets. Since permissible collateral includes not only mortgages but also charges in the broader sense, liens and other guarantees, the room for interpretation open to national legislators in implementing the directive appears so great that the proposal is likely to open the door to significantly more cover assets than are eligible under the German Pfandbrief Act, for example. This extension of the range of assets eligible as cover is at least tolerated by the European Commission – if not actually intended – in order to give credit institutions more possibilities to unlock funding for the real economy.

Thought should at least be given to tightening the requirements with regard to eligibility or to providing further qualitative criteria in order to ensure, not least, that a clear distinction is made between the directive and the ESN initiative (European Secured Notes), which is still being assessed. We recommend supplementing the requirement on high-quality assets with an exhaustive list of eligible assets.

Assets located in third countries

We welcome that assets located in third countries are also to remain eligible as cover. The Member States must examine whether the assets located outside of the EU/EEA meet the requirements of Article 6 and are subject to enforceability similar to that under EU rules. These requirements seem to be appropriate.

Pooling and joint funding

The European Commission's proposal for the directive also seeks, of course, to improve the volume and liquidity of smaller covered bond markets and to enable smaller banks to issue covered bonds at competitive terms. To this end it proposes two mechanisms: first, the bundling of eligible loans of different credit institutions (joint funding) and second, the eligibility of covered bonds within a banking group. The latter mechanism would enable a group parent to include covered bonds issued by its subsidiary in cover for its own covered bond issue. In this context, the group-internal transmission mechanism shall not remain restricted to pledging solutions (claims secured by covered bonds), but should also facilitate the complete sale of covered bonds to the group parent.

We consider both proposals suitable as a means of generating positive stimuli for covered bond markets that so far are under-developed. The question that arises here is why the proposal for the directive permits the two mechanisms only for mortgage lending. It would surely make sense to permit joint funding and pooling solutions for public sector lending, too.

Homogeneity of cover assets

The wording of Article 10 of the draft, which governs the composition of cover pools, is somewhat confusing in that it stipulates that the Member States should ensure that the cover pools are sufficiently homogeneous. The cover assets are expected to meet similar criteria in terms of their structural features, maturity ("lifetime") and risk profile.

This issue is taken from the Principles of Best Practice of the European Banking Authority (EBA) from 2014 and the EBA recommendations of December 2016. However, we do not see any need for action in this respect. For one thing, imprecise legal terms such as "sufficient level of homogeneity" and "similar nature" not only create considerable legal uncertainty – they also lead to divergences in transposition into national law as the respective legislators interpret the provision differently.

Second, the transparency and disclosure requirements have become very detailed in the meantime, so that investors are themselves able to gain a comprehensive view of the composition of the cover pools. As European parlance might have it: there is no need for regulation where there is no "dysfunction". Article 10 should be deleted.

Segregation of cover assets in the event of the bank's insolvency

The provisions of Article 12 on the segregation of cover assets from the other assets in the event of the issuer's insolvency are a core element of the safety of covered bonds. The particular challenge here lies in wording the requirements or mechanisms in such a way that compatibility with all covered bond models in the EU is ensured. This appears, essentially, to have been achieved.

The triggering of asset segregation is likely to depend, however, on whether the issuer falls under the Bank Recovery and Resolution Directive (BRRD); because in that case, the rescue and recovery instruments would come into play, the objective of which is ultimately to preserve the bank, i.e. to avoid special insolvency proceedings in respect of the cover pools. In this context, we would recommend including a specification to this effect in the wording of the directive.

Moreover, the provision ought to be supplemented by clarification to the effect that the segregation of assets has to take place only after insolvency proceedings have been initiated and not already during normal banking operations. Before insolvency proceedings are initiated, it must suffice that the cover assets are identifiable by their being entered in the cover register and are thus distinguishable from the bank's other assets.

Maturity extension

Article 17, which is of a similarly complex nature, defines the conditions for extendable maturity structures which apply to all soft bullet and conditional pass-through (CPT) structures. There are scarcely any statutory regulations on these mechanisms at the national level; the market is characterized by a variety of contractual structures which may differ not only from Member State to Member State but also from issuer to issuer. Against this background, the formulation of legal parameters at the European level would seem to pose a particular challenge, as they have to be sufficiently flexible on the one hand, but also specific enough on the other.

We see a need for rectification in two respects. According to Article 17 (1) (b) of the draft, the maturity extension is not to be triggered at the issuer's discretion. This is a crucial requirement. However, clarification is needed to the effect that the exclusion of discretion refers solely to the phase prior to initiating insolvency proceedings. Once insolvency proceedings have been initiated, the special administrator/cover pool administrator must, of course, have discretionary scope in order to ensure the proper administration of the assets that do not form part of the insolvency estate.

Subsequently, according to Article 17 (1) (e), the maturity extension must not have a negative effect on the ranking of covered bond investors. It is unclear whether the term "ranking" refers to the ranking order of the covered bond creditors in the insolvency proceedings or to the order of priority of the cash flows/payments to the creditors. It needs to be clearly stated that the order of priority of the cash flows is what is meant.

Covered bond public supervision

We welcome the rules contained in Title III of the proposal for the directive which concern public supervision of covered bonds. They strengthen supervisory practice in the Member States, the quality and safety of covered bonds in the EU as well as investor confidence in the covered bond market.

The rules on the competent authorities likewise create clarity. We consider it positive that the national authorities remain responsible not only for the ongoing public supervision but also for the licensing and approval of covered bond programmes. This also applies to the so-called ECB banks. This designation of responsibilities is based on the design of covered bond public supervision as supervision of products with a focus on investor protection and not as the supervision of banks. This prevents a dispute over competence with the Single Supervisory Mechanism (SSM).

Finally, the design of the rules governing the cover pool monitor in Article 13, which was obviously inspired by the principles of the German Pfandbrief Act, is also appropriate. The placing of this provision under Chapter 2, "Cover pool and coverage", makes it clear that the matter of the cover pool monitor does not fall within the scope of public supervision. Thus, the function of a cover pool monitor does not release the authorities designated to perform public supervision from their powers and duties as set out in Articles 18 to 22.

Labelling

Article 27 of the draft introduces the "European Covered Bonds" label for all covered bonds which conform with the directive. The explanatory memorandum states that this label is not intended to replace the denominations used in the respective Member States, and that it is mainly addressed at Member States that do not yet have a denomination or label of their own. Nevertheless, we take the view that such a label should remain restricted to the "premium class" of covered

bonds that conform with Article 129 CRR. The proposal would elevate the substantially broader segment of covered bonds which conform with the directive and leave the premium segment without any form of distinction.

Amendment of Article 129 CRR

The draft of the regulation with regard to Article 129 CRR presented alongside the draft of the directive appears to be coherent. Indeed, there are a number of points where the requirements regarding the preferential risk weighting of covered bonds need to be supplemented or amended and room for interpretation eliminated. For example, the eligibility of Mortgage Backed Securities (MBS) as cover needs to be done away with and MBS should be replaced by intra-group covered bond issues. We welcome the fact that, over and above this, no changes in respect of eligible assets are proposed.

The disclosure and transparency duties contained in Article 129 (7) are then, correctly, moved to the basic directive, and it is made clear that the mortgage lending limits are "soft" limits which make loan splitting possible.

Lastly, substitution assets and requirements on overcollateralization are also introduced. The overcollateralization that will be needed in future for the preferential treatment of covered bonds is set at 5%. Under certain conservative conditions, this ratio may be reduced to 2% for public sector and real estate lending. At this point we would recommend that responsibility for such a reduction should rest with the respective Member State, not with the national supervisory authority.

Conclusion

On the whole, the regulatory package appears to have turned out very well and to be suited to achieving the objectives that have been set. A number of corrections and adjustments are undoubtedly necessary, for example with regard to the definition of the cover assets or the homogeneity of the cover pools. However, the European Commission has provided itself with a good starting point for the legislative procedure going forward and so keeps alive the prospect of finalizing the procedure before the end of this legislative period.

The principles-based design of the wording of the directive inevitably includes a number of legal terms that are unspecific and open to interpretation. However, at this juncture it would not make sense to criticize the legal uncertainty this ostensibly creates, because flexibility will be needed here once the implementation stage gets under way. It will therefore be important to closely monitor and support the transposition into national law and to ensure that the Member States' legislators integrate the European rules into their individual covered bond regimes in a way that is both adequate and consistent with the established or desired practices.

vdp will tackle this task with the requisite commitment.