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Covered Bonds Directive: Impact on UCITS

Background

A new EU framework for covered bonds will come into effect in Ireland on 8 July 2022 following the entry into force of the European Union (Covered Bonds) Regulations 2021 ("**Irish Covered Bonds Regulation**"). The Irish Covered Bonds Regulation gives effect to Directive (EU) 2019/2162 of the European Parliament and of the Council of 27 November 2019 ("**Covered Bonds Directive**") which enters into force on the same date.

The Covered Bonds Directive creates a uniform framework setting down specific structural features which must be satisfied by bonds issued by EU credit institutions which are to be classified as "*covered bonds*"[1] under the UCITS framework.

The current EU framework

Under the UCITS regime, investment in covered bonds is not subject to the standard 5/10/40 issuer exposure rules, and funds may invest up to 25% of net assets in any one covered bond. The total value of investments in covered bonds issued by one issuer cannot exceed 80% of the net assets of the UCITS.

In order for a UCITS to avail of the higher diversification limits, such covered bonds must meet the criteria as provided for in Regulation 70(3)(a) of the European Communities (UCITS) Regulations 2011 as amended ("**Irish UCITS Regulations**"):

- covered bonds must be issued by a credit institution which has its registered office in a Member State and is subject by law to special public supervision designed to protect bond-holders; and

- sums deriving from the issue of covered bonds shall be invested, in accordance with the law, in assets which during the whole period of validity of the bonds are capable of

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[1] A "covered bond" is defined as a debt obligation that is issued by a credit institution in accordance with the provisions of national law transposing the mandatory requirements of the Covered Bonds Directive and that is secured by cover assets to which covered bond investors have direct recourse as preferred creditors.

covering claims attaching to the bonds and which, in the event of failure of the issuer, will be used on a priority basis for the reimbursement of the principal and the payment of the accrued interest.

Difficulties with the current EU framework

Under the current EU framework, there is a lack of harmonisation as to the specific criteria that covered bonds must meet in order for a UCITS to avail of the higher investment limits - as a result, the rules applicable to covered bonds can vary significantly among Member States.

The new EU framework

The Covered Bonds Directive aims to ensure the smooth and continuous development of the covered bonds market in the Union and seeks to limit potential risks and vulnerabilities to financial stability.

Under the new regime, in order to be classified as a "*covered bond*", the relevant bond must have the specific structural features set down in the Covered Bonds Directive meaning that these requirements will now be uniform across all EU Member States.

The new covered bonds framework imposes specific conditions relating to eligible cover assets, composition of the cover pool, coverage and liquidity requirements, amongst others.

Impact on Irish domiciled UCITS

From 8 July 2022, UCITS will only be able to avail of the higher investment restrictions applicable to covered bonds where they are satisfied that the relevant bonds meet the specific criteria as set down in the Covered Bonds Directive.

Covered bonds issued before 8 July 2022 are not affected by the new rules and remain subject to the existing requirements set down in the Irish UCITS Regulations.

Should you have any queries in respect of the issues raised in this article, please do not hesitate to contact your usual Dillon Eustace contact or any member of the Asset Management and Investment Funds Department.

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