EUROPEAN COMMISSION
Directorate-General for Financial Stability, Financial Services and Capital Markets Union

REGULATION AND PRUDENTIAL SUPERVISION OF FINANCIAL INSTITUTIONS
Bank regulation and supervision

CONSULTATION DOCUMENT

COVERED BONDS IN THE EUROPEAN UNION

Disclaimer

This document is a working document of the Commission services for consultation and does not prejudge the final decision that the Commission may take.

The views reflected on this consultation paper provide an indication on the approach the Commission services may take but do not constitute a final policy position or a formal proposal by the European Commission.

The responses to this consultation paper will provide important guidance to the Commission when preparing, if considered appropriate, a formal Commission proposal.

You are invited to reply **by 6 January 2016** at the latest to the **online questionnaire** available on the following webpage:
http://ec.europa.eu/finance/consultations/2015/covered-bonds/index_en.htm

Please note that in order to ensure a fair and transparent consultation process **only responses received through the online questionnaire will be taken into account and included in the report summarising the responses**.

Where appropriate, please indicate the expected impact of this consultation paper on your activities or the activities of firms in your jurisdiction, including estimates of administrative or compliance costs. Please also state reasons for your answers and provide, to the extent possible, evidence supporting your views.

The Commission welcomes any contribution from stakeholders of additional empirical data and analysis on covered bond market trends and performance, in particular as regards signs of fragmentation and market inefficiencies. Furthermore, views are also welcome on of the pros and cons of further integration and the relative desirability of each policy option for a reform agenda as described in this Consultation Paper.

This consultation follows the normal rules of the European Commission for public consultations. Responses will be published unless respondents indicate otherwise in the online questionnaire.

Responses authorised for publication will be published on the following webpage: http://ec.europa.eu/finance/consultations/2015/covered-bonds/index_en.htm#results

EXECUTIVE SUMMARY

Covered bonds are debt obligations issued by credit institutions and secured on the back of a ring-fenced pool of assets referred to as "**cover pool**" or "**cover assets**". Bondholders have direct recourse to the cover pool as preferred creditors, while remaining entitled to a claim against the issuing entity or an affiliated entity of the issuer as ordinary creditors for any residual amounts not fully settled with the liquidation of the cover pool. This double claim against the cover pool and the issuer is denominated the "**dual recourse**" mechanism. The issuer is normally under the obligation to ensure that the value of the assets in the cover pool at least matches at all times the value of the covered bonds and replace assets that become non-performing or, otherwise, stop meeting relevant eligibility criteria. Lastly, the cover pool comprises high quality assets, typically, but not exclusively, mortgage loans and public sector debt.

Although covered bonds have a long history in some Member States, issuance levels have increased more notably in recent years. From an issuer perspective, these instruments have proved a successful countercyclical source of funding which remained resilient against the background of stressed market conditions (see Part I), in particular when compared in issuance volumes to unsecured debt and asset-backed securities ("**ABSs**"). Notwithstanding this relative success, covered bonds were not immune to broader market trends and the challenges faced by the financial crisis in the form of investor retrenchment to their domestic jurisdictions and spread widening. In the words of the Commission's "European Financial Stability and Integration Report"" of 2014, the European banking sector faced two major challenges:

- fragmentation between credit institutions from "core and non-core countries". The Report illustrated this fragmentation by looking at the maturity structure of bank debt, in the light of which it concluded that "banks from core countries benefit from the strength of their sovereigns by being able to finance short term to a larger extent than banks from non-core countries", trend which had only widened throughout the crisis; and

- difficulties to access liquidity which became available only against collateral either in private repo transactions, by issuing secured instruments such as covered bonds, or by pledging assets to central banks, and as a result of which a significant proportion of banks' assets became encumbered.

Tackling fragmentation and market inefficiencies is at the core of the Capital Markets Union project ("**CMU**"), a major Commission's initiative initially launched on 18 February 2015 with a Green Paper which has been followed by an Action Plan adopted on 30 September 2015. As it was acknowledged in the CMU Green Paper, "capital markets today remain fragmented and are typically organised on national lines" and, while progress has been made, "the degree of financial market integration across the EU has declined since the crisis, with banks and investors retreating to home markets". In order to achieve a fully integrated single market for capital, the Green Paper discussed the need for targeted measures to: (i) improve access to finance for all businesses across Europe; (ii) increase and diversify the sources of funding for investors in the EU and internationally; and (iii) make markets work more effectively, linking investors to those who need funding more efficiently and less costly, both within Member States and on a cross-border basis.

Those market integration and efficiency enhancing objectives are also relevant for European covered bond markets which stand out prominently as one of the largest private

debt markets in Europe and a cornerstone of long term finance: they are instrumental for credit institutions to channel cheap finance to the real estate market (namely housing) and the public sector, and have also been used to raise funding on the back of other assets such as loans for the acquisition of aircraft or loans to SMEs. It is appropriate to examine what weaknesses and vulnerabilities covered bond markets exhibited during the financial crisis and, against that backdrop, open a debate with all interested parties on the merits of targeted actions that could be taken to help improve funding conditions on the back of these instruments where issuance faces legal or practical difficulties and facilitate cross-border investment flows within the Union and from third countries. Accordingly, the CMU Action Plan has announced that "the Commission will consult on the development of a pan-European framework for covered bonds, building on national regimes that work well without disrupting them and based on high-quality standards and best market practices. The consultation will also seek views on the use of similar structures to support SME loans."

The Consultation Paper on Covered Bonds in the European Union is structured as follows:

– the appendix contains an in-depth analysis of covered bond market data and trends in recent years, a summary of which is made available for ease of reference in Part I. As pointed out above, market data show relatively strong issuance volumes throughout the crisis years but spread widening in secondary markets could have been a symptom of significant fragmentation on jurisdictional lines, as it occurred elsewhere in European financial and banking markets. The data provide some evidence on the trend towards increased encumbrance in the balance sheets of European credit institutions as a result of the relative decline in unsecured debt issuance during the same period;

– Part II of the Consultation Paper considers the disparity between legal frameworks and supervisory practices of the various Member States that have adopted dedicated covered bond laws as a factor which could have contributed to market fragmentation. Such disparity, which is thoroughly illustrated in the EBA's "Report on EU Covered Bond Frameworks and Capital Treatment" of July 2014 (the "**EBA Report**")[1], may be hindering efforts to promote market standardisation in underwriting and disclosure practices and result in obstacles to market depth, liquidity and investor access (in particular on a cross-border basis). The Consultation Paper discusses the convenience of a reform agenda that would promote a more integrated EU framework for covered bonds based on high quality standards and best market practices. The Paper presents two options:

  a) voluntary convergence of Member States' covered bond laws in accordance with non-legislative coordination measures such as targeted recommendations from the Commission; or

  b) direct EU product legislation on covered bonds, which could seek to harmonise existing national laws or provide an alternative framework.

[1] https://www.eba.europa.eu/documents/10180/534414/EBA+Report+on+EU+Covered+Bond+Frameworks+and+Capital+Treatment.pdf

- on asset encumbrance, Part II notes that other policy initiatives such as the minimum requirement for own funds and eligible liabilities (MREL) laid down in the BRRD, macroprudential measures and targeted powers of supervisors, are more appropriate tools to address this risk. The Consultation Paper notes, however, that a more integrated European covered bond framework could contribute to some extent to mitigating asset encumbrance; and

- Part III discusses a high level design for a hypothetical EU covered bond framework based on the structure and elements set out in the EBA Report. In particular, section 5 of Part III of the Consultation Paper deals with transparency issues which the CMU Green Paper highlighted as a concern noting the disparity of disclosure requirements between covered bonds of different Member States and relative to ABSs

PART I

COVERED BOND MARKETS: ECONOMIC ANALYSIS

This Part summarises the main market trends in European covered bond markets in recent years and provides an assessment of such trends, the full version of which can be consulted in the Appendix to this Consultation Paper.

1. RECENT MARKET TRENDS

1.1 Issuance and outstanding data. Cover assets

As figures I and II show, **global covered bond issuance grew steadily from 2003 to 2012**, with a temporary dip in 2009 and European outstanding exceeding €2.5 trillion by 2014. Another significant trend was an expanded list of countries of issuance during that period, albeit the market remains clearly dominated by European issuers as more than 80% of global covered bond outstanding originates from seven EU Member States (specifically Germany, Spain, Denmark, France, Sweden, Italy, UK) and Norway.

Covered bond issuance and outstanding amounts, however, declined markedly in 2013, which may reflect the on-going contraction of banks' balance sheets, the improved availability of alternative sources of funding, the cancellation of retained deals that had been used as collateral with central banks and publicly issued deals reaching their maturity with no need for new issues. While cross-border disparities have declined in the process, issuance continues to vary considerably between Member States (Figure II), with major economies such as Italy clearly underrepresented in comparison to Germany and Denmark.

Figure I: Cover pool composition and new issuance 2003 - 2014 (Source: ECBC, own calculations)

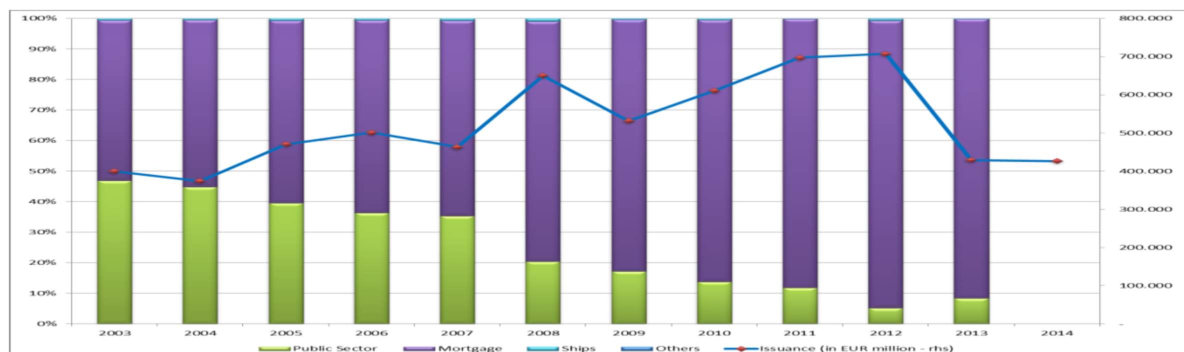


Figure II: Total global outstanding of covered bonds 2003 to 2013 (EUR billion) (source: ECBC)

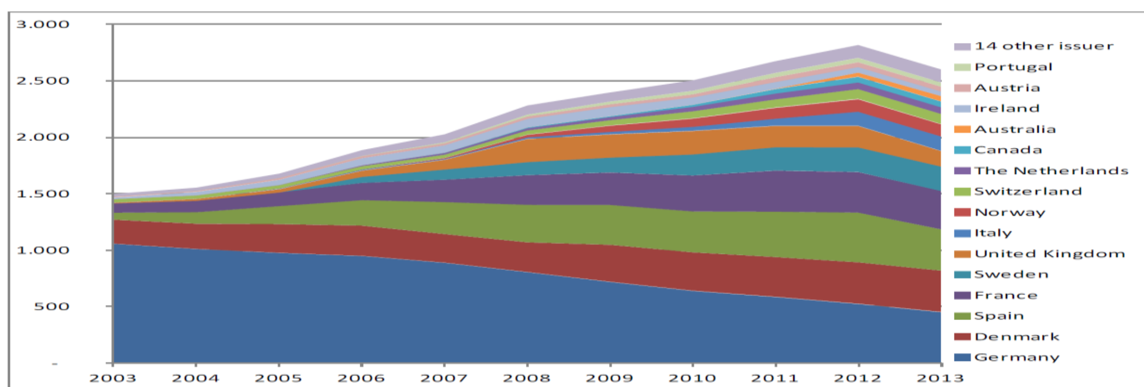


Figure I also shows a clear and increasing predominance of mortgage and other real estate loans (residential and commercial) in cover pools, well ahead of public sector loans and certain other smaller classes such as aircraft, ship or SME loans.

1.2 Secondary market pricing

Although issuance on aggregate remained resilient throughout the crisis compared to other financial instruments, there was **increased dispersion of yields in secondary markets between covered bonds issued from different Member States**, as shown on Figure III. This trend reflected a "flight to safety" among investors who favoured the covered bonds issued from so-called "core" Eurozone Members.

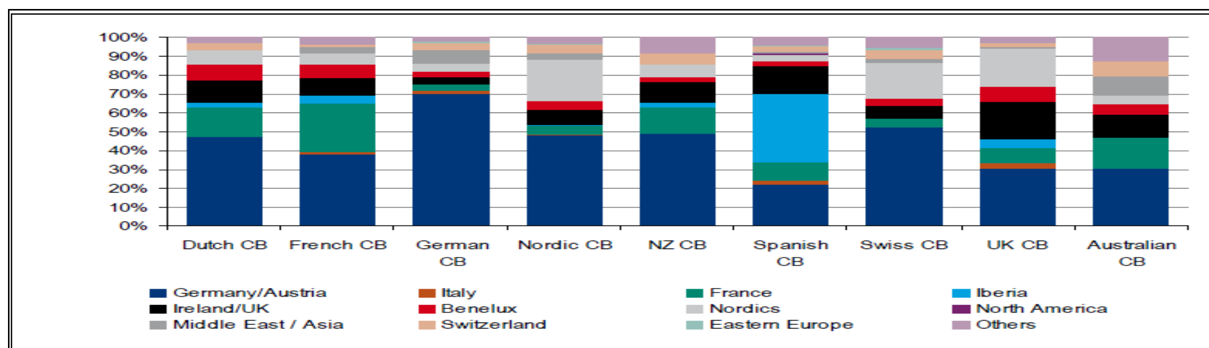
From mid-2012 onwards yield dispersion has eased significantly, probably assisted by ECB asset purchase programmes, although not to the extent of reverting to the pre-2007 trend of very narrow spreads.

Figure III: Covered bond yields in some major European markets (as % MTS indices) (source: Dealogic)

1.3 Investor base

Covered bonds' investor base is relatively well-diversified, with credit institutions representing less than 40% of the total. Furthermore, the geographical distribution of covered bond investors show sizable cross-border investment flows (see Figure IV), with a predominance of German/Austrian investors in the most significant markets, but the crisis has prompted some retrenchment back to domestic markets.

Figure IV: Breakdown of investors by country for each CB market (new benchmark issues) (2014)



Source: BofA Merrill Lynch

2. ASSESSMENT OF STRENGTHS AND VULNERABILITIES

Issuance volumes show that covered bonds remained throughout significant stressed conditions **a more resilient and reliable source of funding** for European credit institutions than unsecured debt and other forms of collateralised lending, such as European ABSs which experienced a dramatic drop in issuance after 2007 from which they have yet to recover.

Key to such good performance is the perception that covered bonds are **low risk instruments**, which is indeed backed by the absence of credit losses for investors throughout the whole history of this instrument, although the bail-out of a number of covered bond issuers undoubtedly contributed to preserving such an unblemished record.

The relative strength of European covered bonds, however, should not mask certain underlying vulnerabilities and challenges.

2.1 Market fragmentation: evidence and reasons?

Given the nature of covered bonds as collateralised debt, their pricing should normally be driven by three main sets of factors: (i) the credit quality of the cover assets; (ii) the repayment capacity of the issuer; and (ii) relevant country factors, which would include both the relative strength of the sovereign and the robustness of the underpinning legal and supervisory framework to deliver effective and credible protection for bondholders.

Prior to 2007, yield contraction between the various European covered bonds showed that investors viewed those as **fundamentally homogeneous assets,** hence of very similar risk characteristics and high credit quality regardless of the Member State of issuance. In this scenario, country factors do not appear to have played a decisive role in investors' decisions, probably on the assumption that covered bonds were backed by substantially similar legal frameworks and, in any event, assisted by the strength of European sovereigns most of which were very highly rated at the time.

The dynamics that existed in covered bond markets changed completely from 2007, as shown in Figure III by the significant yield dispersion between the financial instruments of various Member States that took hold from that year. These data would appear to indicate that **European covered bond markets fragmented on jurisdictional lines and, more specifically, between Member States viewed by markets as core and peripheral (in particular within the Eurozone)**. Although it had started with the onset of the financial crisis, such trend would have been greatly exacerbated by the sovereign crisis from 2010 onwards. In this sense, secondary market pricing would have become dominated by country factors and would have favoured covered bonds issued from

Member States viewed as safer jurisdictions. This market behaviour could be explained in the light of a number of circumstances:

– first, during the initial stages of the financial crisis investors would have become increasingly uncertain about the strength of credit institutions' balance sheets on a standalone basis and, in particular, **about the quality of cover assets, namely in Member States undergoing mortgage market downturns**;

– second, against this background of risk reassessment, European covered bonds would have eventually become a **proxy for sovereign risk in view of the implicit (and, in some cases, explicit) public support for these markets**, as suggested by the close alignment between the yield movements in European covered bonds and those of the government debt of their respective Member States (see Figures V and VI). In other words, it would appear that at a point in time the pricing of covered bonds became driven predominantly by the financial strength of Member States' governments and their banking sectors as a whole, rather than the intrinsic credit quality of the cover assets and the financial soundness of the issuer. This was due to the expectation created by the positive track record of these instruments that public authorities would prop up their covered bond markets in the event of failure of individual issuers (**moral hazard**). In this sense it could be argued that covered bonds became as a whole a **"too big to fail"** market**,** regardless of the systemic nature of individual issuers.

  Having said that, reliance on implicit government support may not have been the only reason for yield alignment between government debt and covered bonds. **Currency re-denomination fears** at the height of the Euro crisis in mid-2012 may have affected these markets in the same way;

Figure V: Covered bond yields

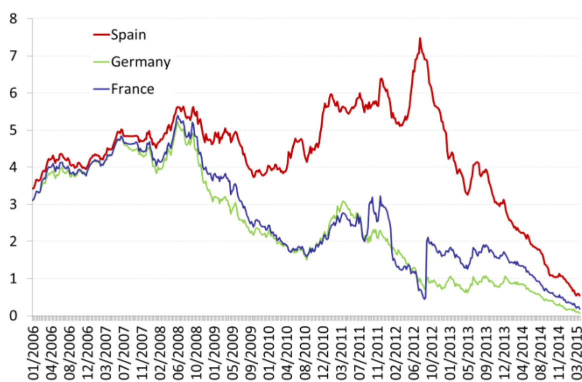
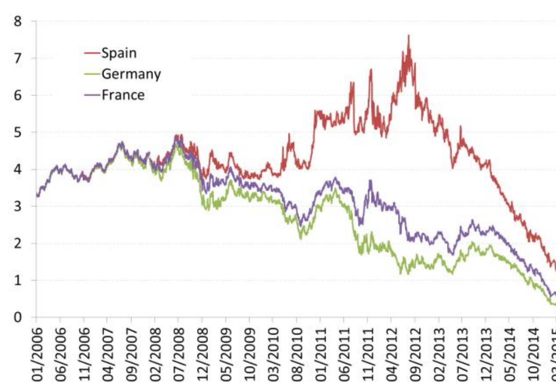


Figure VI: Sovereign bond yields



Source: Bloomberg, European Commission services

– third, fragmentation may also be a consequence of the **stigmatisation of covered bond markets in the worst crisis-hit Member States**. Investors may have viewed those markets gradually as less robust and reliable and become ultimately unwilling to rely on the ability of their institutional and legal setting to deliver effective protection to bondholders through special public supervision and asset segregation. Such concerns would point to three key weaknesses/challenges in the legal and institutional construct of covered bond markets in general:

a) the **legal segregation of the cover assets** from the issuer in the event of insolvency or resolution remains largely untested, given that no issuers were allowed to fail. This may create doubts among investors about the effectiveness of the dual recourse mechanism and reinforce the expectation from the market that covered bond issuers will be bailed-out;

b) **transparency** on the collateral pool is deemed by some market commentators as suboptimal, in particular when compared to ABSs, and **both disclosure on and eligibility of cover assets** are subject to disparate requirements between Member States, thus hindering liquidity and market depth, preventing comparability between covered bonds from different jurisdictions and creating barriers to entry for investors; and

c) confidence in the ability of **special public supervision** to deliver credible protection for bondholders may have been somewhat tarnished by the financial crisis.

2.2 Asset encumbrance and interaction with Asset Backed Securitisations (ABSs)

Notwithstanding the challenges described above, covered bond issuance exceeded senior unsecured issuance in Euro markets during the financial crisis for the first time in history, becoming the main and sometimes only source of funding for many credit institutions in the worst crisis-hit Member States other than central bank funding. This trend, together with a more general increased reliance on secured funding, has resulted in **high levels of asset encumbrance in credit institutions' balance sheets.**

Asset encumbrance raises concerns among supervisors and policy makers for two main reasons:

– encumbered assets become unavailable to support the resolution of credit institutions in accordance with Directive 2014/59/EU (the "**BRRD**"), which may, as a result, increase credit losses for unsecured creditors and taxpayers; and

– asset encumbrance reduces the pool of assets available to the issuer to obtain liquidity in the event of unforeseen stresses.

Covered bonds, however, are not the only source of asset encumbrance and this issue needs to be examined holistically taking into account other forms of collateralised funding and the relative importance of unsecured funding for any given credit institution. The BRRD requires that credit institutions, including covered bond issuers, meet a minimum requirement on own funds and eligible liabilities available for bail-in (MREL)[2], which can act as an indirect limit on asset encumbrance.

Some market commentators have argued that covered bonds have become the main source of asset encumbrance for European issuers as a result of the preferential treatment provided for them by the EU regulatory framework (see section 1 in Part II). It has been claimed, in particular, that such beneficial treatment and lower operational costs would

[2] MREL, however, does not apply to mortgage credit institutions financed by covered bonds which are not allowed to receive deposits according to national law (article 45 of BRRD).

have resulted in covered bond issuance crowding out European ABS[3]. However, it should be noted that under current regulatory capital rules for credit institutions highly rated ABS can be subject to capital requirements that are just as low or even lower. It is therefore unclear if such crowding out, if it is in fact taking place, is actually driven by regulation. To the extent that a certain preference for covered bonds over ABS results from their lower operational costs, there may be net gains connected to the use of covered bonds instead of ABS. Lower operational costs can, for instance, result from a well-defined legal framework that obviates the need to develop highly complex transaction documentation.

QUESTIONS – COVERED BOND MARKETS: ECONOMIC ANALYSIS

1. **In your opinion, did pricing conditions in European covered bond markets converge and diverge before and after 2007, respectively? If so, what where the key drivers of this convergence/divergence? Please, provide evidence to support your view.**

2. **Was pricing divergence an evidence of fragmentation between covered bonds from different Member States? Do you agree with the reasons for market fragmentation described in section 2.1 of Part I? Were there any other reasons?**

3. **In your view, is there any evidence of pricing differentiation/fragmentation between covered bond issuers on the basis of size and systemic importance, as well as their geographical location?**

4. **Is there an appropriate alignment in the regulatory treatment between covered bonds and other collateralised instruments? If there is a misalignment, could you illustrate what differences in regulatory treatment you deem as inappropriate and why?**

5. **Are operational costs for covered bond issuance lower than for other collateralised instruments? Can you quantify the respective costs, even if only approximately?**

6. **Are there significant legal or practical obstacles to:**

    a) **cross-border investment in covered bond markets within the Union and in third countries?; and**

    b) **issuance of covered bonds on the back of multi-jurisdictional cover pools?**

    Please provide evidence to support your views.

[3] ABSs are securities issued by special purpose vehicles (SPVs) on the back of a pool of assets acquired by the SPV from an originator. In European ABS markets, the originator is typically a credit institution and the assets loans originated as part of its ordinary banking business, including mortgage loans that may be eligible as cover assets for covered bonds. Unlike the latter, however, ABSs are liabilities of the issuing SPV and investors only have recourse to the pool of assets acquired by the SPV to back the ABSs but not to the originator (in other words, there is no dual recourse).

PART II

EXPLORING THE CASE FOR A MORE INTEGRATED FRAMEWORK

1. CURRENT LEGAL/REGULATORY FRAMEWORK

The development of covered bonds as funding instruments has been assisted by supporting legal frameworks, which typically enshrine the so called "dual recourse mechanism" by virtue of which the bondholder has a claim both on the issuer on a full recourse basis and on the cover pool on a priority basis in the event of the issuer's insolvency/liquidation.

In the EU the regulation of covered bonds as a debt instrument is currently a matter left entirely to Member States' national laws, 26 of which have implemented dedicated legislation. National laws set out a more or less extensive set of requirements on a variety of subject matters, such as: (i) the authorisation of credit institutions as licensed covered bond issuers; (ii) special public supervision of the issuer and the cover pool and monitoring of the latter; (iii) types of eligible cover assets and certain minimum qualitative standards applicable to those; (iv) segregation of the cover pool upon insolvency of the issuer; and (v) standards of disclosure to investors on the cover pool. The EBA Report provides a detailed account of the similarities and differences between the covered bond laws of Member States.

EU law, on the other hand, does not regulate covered bonds directly but lays down their prudential treatment for a variety of purposes:

- Undertakings for Collective Investment in Transferable Securities (UCITS): Article 52(4) of Directive 2009/65/EC (the "**UCITS Directive**") allows higher investment and concentration limits for UCITS investing in "covered bonds". These are only defined by reference to three high level structural principles which have become the cornerstone of covered bond legislation as implemented by the laws of Member States. These principles are as follows:

    a) the bonds must be issued by a credit institution which has its registered office in a Member State;

    b) the issuer must be subject, by law, to special public supervision designed to protect the covered bondholders; and

    c) sums deriving from the issue of the covered bonds must be invested in accordance with the law in assets which, during the whole period of validity of the bonds, must be capable of covering claims attaching to the bonds and which, in the event of failure of the issuer would be used on a priority basis for the reimbursement of the principal and payment of accrued interest;

- regulatory capital requirements for credit institutions: Article 129 of Regulation (EU) No 575/2013 (the "**CRR**") lays down a set of minimum requirements in relation to the cover assets and levels of transparency to investors that the covered bonds referred to in Article 52(4) of UCITS Directive must meet in order to benefit from "preferential risk weights" for credit risk. In other words, credit institutions investing in covered bonds qualifying under Article 129 are allowed to hold lower levels of

regulatory capital in relation to those instruments than would apply to senior unsecured bank debt (e.g. 10% risk weight for a "credit quality step 1" covered bond compared to 20% for another type of direct exposure to a credit institution of the same step);

- capital requirements for (re)insurance undertakings investing in covered bonds are laid down in Article 180(1) of the Commission's Delegated Regulation (EU) 2015/35 ("**Solvency II Delegated Act**"). Covered bonds are defined as in Article 52(4) of the UCITS Directive and, provided they are highly rated, they attract specific risk factors lying between those applicable to corporate bonds and government bonds;

- liquidity of credit institutions: Commission's Delegated Regulation (EU) 2015/61 (the "**LCR Delegated Act**") allows credit institutions to treat covered bonds as liquid assets of level 1, if they qualify as "extremely high quality covered bonds", or as level 2, if they are so called "high quality covered bonds", for the purposes of calculating their "liquidity coverage ratio" ("**LCR**"). The LCR Delegated Act sets out a number of specific criteria to differentiate between covered bonds of level 1 and 2 but in substance incorporates by reference the well-established covered bond definition contained in Article 52(4) of the UCITS Directive;

- the BRRD excludes "covered bonds" from the scope of the bail-in tool and mandates Member States to "ensure that all secured assets relating to a covered bond cover pool remain unaffected, segregated and with enough funding" in the event that resolution authorities exercise write-down or conversion powers in relation to the liabilities of a credit institution. "Covered bonds" are, again, defined by reference to Article 52(4) of the UCITS Directive.

This catalogue of prudential provisions has brought about some degree of harmonisation between the covered bond laws of Member States, albeit only indirectly. For instance, Member States' laws implement the three principles set out in Article 52(4) of the UCITS Directive and generally follow the credit quality and underwriting standards set out in Article 129 of the CRR for the underlying cover assets. However, as the EBA Report shows national covered bond laws appear quite disparate in some key technical aspects and, accordingly, it cannot be said that there is a common “European” covered bond instrument or set of standards beyond some high level principles for prudential purposes.

2. BENEFITS AND CHALLENGES OF AN INTEGRATED FRAMEWORK

It was said in Part I that covered bonds are perceived by investors as low risk instruments, which provides the rationale for the various beneficial prudential treatments in EU law reviewed in section 1 of this Part. The EBA Report concluded in their response to the call for advice from the Commission on covered bond capital requirements in accordance with Article 503 of the CRR that: *"Due to the good historical default/loss performance of covered bonds in the EU, the dual recourse principle embedded in covered bond frameworks (...), the special public supervision (...) and the existence of qualifying criteria in Article 129 of the CRR,* ***the EBA considers the preferential risk weight treatment laid down in Article 129 of the CRR to be, in principle, an appropriate prudential treatment.****”*.

Without prejudice to this overarching conclusion, the EBA finds that the qualifying criteria contained in Article 129 of the CRR fail to deal with other *"relevant aspects of*

safety of covered bonds" and recommends giving consideration to the opportunity of complementing those with further criteria on the role of the competent authority, liquidity risk mitigation, overcollateralisation and disclosure to investors. As noted in section 1 of this Part, the Report finds significant differences in the way these and other matters are dealt with by the covered bond laws of Member States, to name a few:

– in relation to the **system of special supervision**, there are different models to authorise/license covered bond issuers and programmes (see, for example, Table 26 in the EBA Report) and the role and duties on the authority in relation to on-going and post-default supervision of the issuer and the cover pool vary in each Member State. Although not pointed out by the EBA, it is also worth noting that the Single Supervisory Mechanism ("**SSM**") does not currently have direct responsibility in the special supervision of covered bonds issued by the credit institutions that it covers;

– on the **features of the cover pool**, Tables 13, 14 and 15 of the EBA Report show the diverse LTV, valuation and eligibility criteria that the laws of Member States apply on mortgage assets, ranging for example from no LTV limit at all to a maximum of 200% in one Member State;

– on **measures to manage mismatches between cover assets and liabilities**, Tables 16 and 17 show the lack of a common definition of **coverage principle** and the different types of **coverage stress tests** which are imposed on issuers throughout the EU. Further, the Report notes the absence of a consistent minimum requirement on **overcollateralisation**, with again a broad range of legislative/regulatory options (from no minimum OC level to required values of over 40%). On liquidity risk, Tables 22 and 23 illustrate how the laws of Member States differ on matters such as the regulatory limits on the **use of complimentary/substitution assets** or on the requirement to hold a **liquidity buffer** and the features of it;

– finally, on **transparency** (disclosure to investors), the EBA considers that transparency and disclosure practices and requirements in the EU are highly fragmented and inconsistent and noted "investors' uncertainty about the compliance of certain covered bond programmes with Article 129 of the CRR" as this provision "may leave excessive room for interpretation for both issuers and competent authorities".

In addition to the targeted areas identified above, the EBA recommends in the longer term that "***further convergence of national legal/regulatory and supervisory covered bond frameworks should be achieved****, so as to further* ***support the existence of a single preferential risk weight treatment*** *in the EU"*. The EBA's Report also points to "best practices" in national covered bond laws and covered bond supervision that have been identified within the range of practices that exist across Member States.

It was also said in Part I that European covered bond markets would appear to have fragmented on jurisdictional lines and, more specifically, between Member States viewed by markets as core and peripheral (in particular within the Eurozone). Disparate supervisory practices and legal requirements in the covered bond laws of Member States, as singled out in the EBA Report, could have contributed to the fragmentation of markets due to the absence of **a set of common high quality standards for all covered bonds in the EU** capable of preventing or mitigating the stigmatisation of covered bonds issued in the worst crisis-hit Member States. In order to address the risks and challenges described in Part I, it may be appropriate to go beyond the narrow scope of prudential regulation

recommended by the EBA and pursue a more ambitious reform agenda for convergence of national laws towards a truly integrated and comprehensive covered bond framework, thus capable of delivering **a recognisable "European covered bond instrument"**. This approach would be consistent with the market integration and efficiency enhancing objectives of the CMU and other like-minded private-led initiatives (notably the "Covered Bond Label" that will be referred to in section 3 of this Part) and could unlock a number of potential benefits for participants in covered bond markets and for the general economy, such as:

– **improve market discipline and efficiency** through enhanced transparency and comparability between covered bonds of different Member States. In particular, better disclosure practices could be instrumental to **reducing moral hazard**, provided that investors had access to sufficiently granular information to price covered bonds on the basis of the issuer's financial strength, the credit quality of the cover assets and the robustness of the programme structure, and not on the expectation of support from the sovereign[4];

– facilitate **simplification and standardisation in market practices currently pursued by market participants and help develop deeper and more liquid covered bond markets** for all Member States, which could become, as a result, a more consistently safe and predictable source of funding[5];

– **reduce the home bias in the investor base (see Part I) and encourage more cross-border issuance and investment**, both within the Union and from third countries, insofar as common standards would prevent an undue or unjustified distinction between stronger and weaker instruments;

– **reduce costs and time currently needed to undertake separate analysis for the covered bonds of each Member State based on their different legal frameworks**. Such costs create barriers to entry for smaller or less sophisticated investors and inhibit issuance growth in Member States where the market is smaller;

– **facilitate the application of the prudential requirements listed under section 1 of this Part**, which would then be applied to covered bond instruments of more comparable and consistent levels of credit quality and liquidity. Furthermore, an integrated framework could be relied upon to **mitigate or eliminate the current mechanistic reliance on external ratings** by providing a more risk sensitive and comprehensive basis for the prudential treatment of covered bonds;

– **enhance the effectiveness of and facilitate the coherence in the transmission of the ECB's and other central banks' monetary policies** as a result of a larger availability of covered bonds for the purpose of outright transactions.

[4] An EU integrated covered bond framework could be viewed as necessary to complement Regulation (EU) No 1024/2013 (the "**SSM Regulation**") and the BRRD, insofar as the covered bond market seems to present a case of market-sovereign link rather than bank-sovereign link which those legal instruments address (see subsection 2.1 in Part I)

[5] A further benefit to covered bonds issuance is that, compared with sight deposits, they help reduce maturity mismatches in banks' balance sheet and enhance financial stability as a result.

Asset encumbrance risks could also be partly mitigated through an adequately narrow definition of eligible cover assets that would reduce incentives to encumber a larger population of assets, in particular those of lower quality. Moreover, enhanced investor confidence may contribute to reducing the **high levels of overcollateralisation** currently required for covered bond programmes in the worst crisis-hit Member States. It should be noted, however, that a more integrated EU covered bond framework could not address asset encumbrance risks directly, unlike intrinsic vulnerabilities of covered bond markets such as fragmentation or insufficient transparency. Rather, asset encumbrance is a by-product of covered bond issuance and other forms of collateralised lending which may result in potential systemic issues and should be tackled through other policy measures such as the MREL, as pointed out above, macroprudential tools and targeted powers of supervisors.

Against the potential benefits described above, a reform agenda pushing for more convergence at an EU level should proceed very cautiously to avoid disrupting existing covered bond markets, in particular those which exhibited a stronger performance, or stifling market innovation. Further, it should seek to ensure coherence with other EU-level policy agendas and projects to promote high quality standards in European capital markets, namely the Simple, Transparent and Standardised (STS) securitisation project, and reconcile both the protection of covered bondholders and unsecured creditors of issuers in resolution.

3. POLICY OPTIONS FOR INTEGRATION IN COVERED BOND MARKETS

The drive for reform has been led initially by market participants through very valuable initiatives such as the "Covered Bond Label" of the European Covered Bond Council ("**ECBC**"). Under this initiative, covered bond programmes must meet a set of pre-defined characteristics which require a number of "legislation safeguards" and "security features intrinsic to the covered bond product" to qualify for the Label. Further, these core characteristics are complemented by a transparency tool developed at national level based on the "Guidelines for National Transparency Templates"[6].

Although market-led initiatives are aimed at improving quality standards and transparency of covered bond programmes to enhance investor confidence, there are limitations to how far they can get without meaningful legislative reform backing them. In particular, market-led initiatives may only operate in relation to the contractual aspects of covered bond programmes but cannot address some of the key features of covered bonds as defined in applicable laws such as the system of public supervision or the insolvency/resolution remoteness of the cover pool. Furthermore, the ability of market-led initiatives to apply high quality standards across the entire market relies on voluntary compliance. These challenges are better illustrated by the difficulties to push for more comprehensive and consistent disclosures to investors as described in the EBA Report, insofar as templates developed by industry associations differ substantially between each other, Member States and asset classes and have not been adopted universally by all covered bond issuers.

If legislative measures were envisaged to foster reform towards a more integrated framework for European covered bonds, there are broadly two options that could be followed.

[6] https://coveredbondlabel.com/

- ***Option 1: Subsidiarity and indirect harmonisation***

  As described in section 1 of this Part, the current covered bond framework relies on substantive legislation on the instrument by Member States and indirect harmonisation through prudential requirements in EU law. One option would be to leave the current balance of competences unchanged but encourage greater convergence in covered bond laws through **voluntary, non-legislative coordination measures.** To this end, the Commission could issue recommendations to Member States to implement the EBA's best practices in their national legal frameworks.

  In this case, further thought would need to be given to the recommendations from EBA in favour of strengthened eligibility criteria for the existing preferential treatment in the CRR. Such strengthened eligibility criteria could provide an additional incentive for Member States to converge their legislative frameworks.

- ***Option 2: EU product regulation – elements and shape of an integrated framework***

  An alternative to voluntary convergence of Member States laws would be for the Commission to promote such convergence directly through **a dedicated EU covered bond legislative framework** which would regulate covered bonds as a legal instrument rather than just their prudential treatment[7]. The framework could include provisions on the following high level elements:

  I. covered bond definition and protection of the term;

  II. covered bond issuers and system of public supervision:

  a) issuer models and licensing requirements;

  b) on-going supervision and cover pool monitoring (pre-insolvency);

  c) covered bonds and the SSM.

  III. dual recourse and insolvency/resolution regime;

  a) definition of dual recourse principle;

  b) segregation of the cover assets;

  c) administration and supervision of the cover pool post-insolvency;

[7] The original UCITS Directive (85/611/EEC) was a similarly-minded initiative. By applying the same requirements on open-ended funds investing in transferable securities in every Member State, it aimed at removing cross-border barriers between Member States, further the Single Market and encourage sustainable investment growth in this product. The result of the UCITS legislation can be considered a success story of market integration facilitated by legal harmonisation: UCITS assets under management have multiplied by 8 in 20 years and currently stand at €8 trillion. Furthermore, the UCITS legislation has become the collective investment fund framework of reference, in Europe and internationally, facilitating not only intra-European investment flows but also investments from third countries (for instance, approx. 10% of UCITS assets are currently held by Asian and Latin American investors).

d) interaction between cover pool and issuer in insolvency/resolution;

IV. the cover pool:

a) eligible assets: qualifying criteria and requirements;

b) coverage requirement and overcollateralisation;

c) cover/assets liabilities risk mitigation: market and liquidity risks;

V. transparency requirements.

A dedicated EU covered bond legislative framework could be achieved through various degrees of harmonisation of the above elements in national covered bond laws in accordance with a directive. This could provide a flexible approach by combining detailed requirements in some areas and high level principles in others, and offering a choice between minimum and maximum harmonisation as appropriate. A directly applicable regulation that would replace at least partly covered bond laws of Member States would be another option, but it would appear more challenging at this stage given that covered bond laws are well developed and deeply-rooted in the legal tradition of many Member States.

An EU covered bond legislative framework seeking to harmonise existing national laws would need to provide clarity on the treatment of legacy covered bonds and, accordingly, careful consideration should be given to grandfathering or transitional provisions

As a substitute for harmonisation, a comprehensive EU law framework for covered bonds (29th Regime) could be made available for issuers to resort to as an alternative to national laws. This option would offer the benefit of providing a fully integrated regime for issuers on a voluntary basis and would not require any amendments to existing national covered bond laws. However, a disadvantage of this alternative would be increased fragmentation in the short run before sufficient issuance volume was reached under the new framework.

Part III of this Consultation Paper sets out a detailed analysis of the elements for a hypothetical EU covered bond framework as suggested in this subsection.

QUESTIONS – LEGAL FRAMEWORK AND INTEGRATION

1. **Would a more integrated "EU covered bond framework" based on sound principles and best market practices be able to deliver the benefits suggested in section 2 of Part II? Are there any advantages or disadvantages to this initiative other than those described in section 2 of Part II?**

2. **In your view, are market-led initiatives such as the "Covered Bond Label" sufficient to better integrate covered bond markets? Should they be complemented with legislative measures at Union or Member State level?**

3. **Should the Commission pursue a policy of further legal/regulatory convergence in relation to covered bonds as a means to enhance standards and promote market integration? If so, which of the options suggested in**

section 3 of Part II should the Commission follow to that end and why?

4. **Specifically, if the Commission were to issue a recommendation to Member States as suggested in section 3 of Part II would you consider that sufficient or should it be complemented by other measures (both legislative and non-legislative)? (see question 8 below)**

5. **On the suggested list of high level elements for an EU covered bond framework:**

   a) **is the list sufficiently comprehensive or should it include any other items?**

   b) **should the Commission seek to develop all the elements or a subset of them?**

   c) **if only a subset, should the Commission give priority to the target areas identified by the EBA Report: (i) special public supervision of cover pools and issuers; (ii) characteristics of the cover pool; and (iii) transparency?**

6. **What are your views on the merits described under section 3 of Part II of using different legal instruments to develop an EU covered bond framework? In particular, would it be desirable to harmonise through a directive some of the legal features of covered bonds and requirements applicable to them under Member States' laws? If it were proposed, how could a 29th Regime on covered bonds be designed to provide an attractive alternative to existing national laws?**

7. **How should an EU covered bond framework deal with legacy transactions?**

8. **Would you view a combination of recommendations to Member States (Option 1) and targeted harmonisation of certain minimum standards (Option 2) as desirable and sufficiently flexible? If so, what should be the subject of each option?**

PART III - ELEMENTS FOR AN INTEGRATED COVERED BOND FRAMEWORK

This Part elaborates on each of the proposed elements for a hypothetical EU covered bond framework as set out under section 3 of Part II, providing a high-level approach that could be reflected in a eventual legal instrument and/or set of recommendations. Both the structure and the proposals are largely based on the best practices recommended by the EBA, although some elements have been added for consideration.

Stakeholders are invited to review and respond to the questions set out under each applicable subsection in this Part. For the avoidance of doubt, references to the "Framework" should be construed as references to any potential EU legal instrument (directive or regulation and potential delegated and implementing acts) and/or recommendations to Member States in accordance with the two Options outlined under section 3 of Part II, in each case as appropriate. References have been made to EBA or ESMA supervisory guidelines where these could be envisaged.

1. COVERED BOND DEFINITION

1.1 New legal definition

The Framework could repeal the current definition of "covered bond" set out in Article 52(4) of the UCITs Directive with a new definition that would describe these as secured debt instruments issued by credit institutions and meeting all other applicable requirements laid out therein. The three key elements of Article 52(4) (see section 1 of Part II) would be duly replicated and expanded as part of the new EU covered bond Framework. However, the first requirement on the location of the issuer could be supplemented with a system of recognition of "equivalent third countries" for issuers with their registered office in a non-EEA country (see subsection 1.3 of this Part below).

The legal definition of "covered bonds" under the Framework could be supplemented with the following:

- the term "regulated" could be added to the legal denomination to distinguish qualifying covered bonds from non-qualifying instruments using covered bond structures; and/or
- a system of certification of qualifying instruments which could be added to a list maintained by ESMA or EBA.

For the sake of clarity and transparency towards investors and in order to avoid contagion from lower quality instruments in a crisis, the Framework could protect the denomination “covered bonds” or "regulated covered bonds" and that of qualifying national instruments (Pfandbrief, etc.) and limit their use in marketing materials to instruments that conform to the European Framework.

In the event of an alternative EU law framework (29th Regime), covered bonds issued under the Framework would coexist with covered bonds issued under Member States' laws. Accordingly, the Framework would have to take due account of both for legal definition and protection of denomination purposes.

1.2 Interaction with prudential requirements

As the Framework would replace the definition of covered bonds in Article 52(4) of the UCITS Directive, all references to "covered bonds" in EU law currently relying on this Article should instead refer to the new legal definition in the Framework which, accordingly, would set out the relevant conditions for the eligibility of covered bonds for all applicable prudential regulatory purposes.

In relation to Article 129 CRR, the provisions in the Framework dealing with the cover pool and transparency could be used as new criteria for the assignment of preferential risk weights and replace the high level criteria set out in that Article.

1.3 Equivalent covered bonds in third countries

The Framework could provide for the identification of "equivalent covered bonds" issued by credit institutions with their registered office in a non-EEA country, in particular for the prudential regulatory purposes referred to subsection 1.2 of this Part. The equivalence assessment would look into whether:

- the relevant third country has covered bond laws in force which are equivalent to the EU covered bond Framework in terms of: (i) public supervision; (ii) double recourse; (iii) insolvency remoteness for bondholders; (iv) eligible cover assets and protection from cover pool risks (including overcollateralisation); and (v) transparency;
- the third country performs public supervision in an equivalent way;
- the eligible assets for the cover pool in the relevant third country are subject to equivalent characteristics and underwriting standards to those applied to eligible assets under the Framework; and
- the relevant third country applies prudential and regulatory requirements to issuing credit institutions at least equivalent to those applied in the European Union, as per Article 107(4) of the CRR.

Third country covered bond regimes assessed as "equivalent" would be published on a list maintained and updated on a regular basis by ESMA or EBA.

QUESTION – COVERED BOND DEFINITION

What are your views on the proposals set out in section 1 of Part III for a "new legal definition" of covered bonds to replace Article 52(4) of the UCITS Directive?

2. COVERED BOND ISSUERS AND SYSTEM OF PUBLIC SUPERVISION

2.1 Issuer models and licensing requirements. Role of SPVs

As illustrated in the EBA Report (see Table 5), Member State laws provide for different covered bond issuer structures, which can be broadly classified as follows:

- "universal" credit institution issuer models, where a credit institution with diversified business and funding sources issues the covered bonds directly. It is noted that in this

model the cover assets remain on the balance sheet of the issuer but are legally ring-fenced in favour of the covered bondholders and these have a preferential claim over the assets;

- "specialised" credit institution issuer models, where the issuer is legally restricted in the range of business activities it can engage to lending or acquiring certain qualifying assets and funding those activities mostly or exclusively through the issue of covered bonds backed by those assets. This model features different structures, from mortgage banks as in Denmark or Luxembourg that both lend to end-customers and issue covered bonds, to instrumental-type of issuers such as the French *Sociétés de Financement de l'Habitat* or *Sociétés de Credit Foncier* ("**SCF**") which issue covered bonds on the back of assets originated by other credit institutions which are typically part of the same group;

- structures with "universal" credit institution issuers establishing unregulated special purposes vehicles (SPVs) at issuance as an insolvency remote company to which the cover assets will be transferred in the event of issuer's failure/default (UK, Italy and the Netherlands). The Report explains that this structure is used as a means "to enhance the extent of segregation of the cover assets from the issuer and, therefore, to enhance the quality and legal reliability of the priority claim enjoyed by the investor on the cover assets".

In addition, as shown in Table 26 of the EBA's Report there is a multiplicity of licensing systems across Member States which may include: (i) credit institution licensing; (ii) one-off covered bond-specific licensing; (iii) authorisation prior to each covered bond programme; (iv) notification of each covered bond programme; or (v) notification of each covered bond issue (within a programme). Ad-hoc licensing requirements (that is, those in addition to credit institution licensing) are due to the existence of specific prudential requirements on covered bond issuers beyond those applying to credit institutions generally under the CRR.

The EU Framework would seek to recognise all existing issuer models as described above in accordance with the following principles:

- any credit institution authorised in any Member State as such in accordance with the CRR (Article 4.1(1)) and the CRD would be permitted to issue qualifying covered bonds;

- specialised covered bond issuers authorised in accordance with ad-hoc national laws would also be qualifying issuers under the Framework provided they complied with the specific requirements set out in those laws. For clarity, the Framework could include a list of such issuers and their applicable laws;

- the use of SPVs and pooled structures could be expressly permitted, both to ring-fence cover assets as in existing models or as issuers on the back of pools of cover assets originated by other credit institutions.

It would appear desirable to streamline the multiplicity of licensing systems for issuers and programmes and harmonise the additional prudential requirements applicable to

covered bond issuers, provided that a reasonable common ground can be found between the various legal systems.

QUESTIONS – ISSUER MODELS AND LICENSING REQUIREMENTS. ROLES OF SPVs

1. **Should the current licensing system be simplified to require a "one-off" authorisation only for all covered bond issuers based on common high level standards? What specific prudential requirements (that is, in addition to those in CRR and CRD) could be applied as a condition for granting a covered bond issuer license?**

2. **If the covered bond issuer is subject to a one-off covered bond-specific licence, what would be the additional benefits of requiring that each covered bond programme be subject to prior authorisation as well? Alternatively, would pre or post notification to the competent authority of the programme and of each issue within or amendment to the programme suffice? How should "covered bond programme" be defined for these purposes?**

3. **Should the Framework explicitly allow the use of SPVs to ring-fence cover pools of assets backing issues of covered bonds? What specific requirements should apply to these SPVs?**

4. **Regarding the use of pooled covered bonds structures and SPVs:**

   a) **would it be desirable for an EU covered Bond Framework to allow the use of these structures and why? What legal structures are used in your jurisdiction to pool assets from different lenders or issuers?**

   b) **which approach would be the most suitable for pooling assets across borders?**

   c) **where the issuer of pooled covered bonds is an SPV, should this issuer be regulated as a credit institution or as some other form of legal entity?**

2.2 On-going supervision and cover pool monitoring (pre-insolvency)

The on-going supervision of covered bond issuers and programmes comprises a variety of oversight actions undertaken by competent authorities post-licensing of the issuer and/or programme and prior to the issuer's becoming insolvent or in resolution. The EBA Report notes that on-going supervisory practices cover the following areas:

- implementation of regular on-site inspections;
- implementation of supervisory guidelines specific to covered bond issuance business;
- issuer reporting requirements;
- supervision of asset eligibility and asset valuation criteria;

- supervision of coverage calculations;
- prompt corrective action practices; and
- on-going monitoring of the cover pool.

As noted in subsection 2.1 of this Part, the establishment of and amendments to covered bond programmes are subject in many Member States to ad-hoc licensing/authorisation or notification requirements, in relation to which a specific question has been put forward as to whether it would be desirable to harmonise and simplify such processes.

As the EBA Report recommends, the EU covered bond Framework should provide for a "clear and sufficiently detailed illustration of the duties and powers of the competent authority regarding the on-going supervision of the applicable activities/regulatory requirements of covered bond issuers". A common set of duties and powers for all competent authorities based on high quality standards would contribute to enhancing confidence in European covered bond markets and improve investor protection.

As noted in the EBA Report, many covered bond laws of Member States require cover pools to be monitored by an independent third party (the "**cover pool monitor**") appointed by the competent authority or the issuer as an additional layer of review of compliance by the issuer with certain legal obligations. For instance, cover pool monitors typically perform audits on the cover pool, verify compliance with coverage tests and report directly to the competent authority. Accordingly, an EU covered bond Framework could provide for the following:

- a requirement on the issuer or the competent authority to appoint an independent third party as monitor of the cover pool;
- professional eligibility criteria that a person or legal entity should meet to be appointed as cover pool monitor;
- specific duties that the cover pool monitor would be bound to, tasks that he or she should perform and a liability regime; and
- a passporting mechanism that would allow cover pool monitors to offer their services in other Member States.

QUESTIONS – ON-GOING SUPERVISION AND MONITORING OF COVER POOLS (PRE-INSOLVENCY)

1. **In your view, would it be desirable for an EU covered bond Framework to set common duties and powers on competent authorities for the supervision of covered bond programmes and issuers? What specific duties and powers should be included in the Framework and/or EBA or ESMA Guidelines?**
2. **What are your views on the proposals set out in subsection 2.2 of Part III on the appointment of and legal regime for cover pool monitors?**

2.3 Covered bonds and the SSM

The Single Supervisory Mechanism established by SSM Regulation gives direct supervisory powers to the European Central Bank (ECB) on the largest credit institutions in the Euro area and in those non-Euro Member States that choose to join the SSM (the "**Participating Member States**"), while national competent authorities retain direct supervisory powers on the remaining credit institutions in the participating Member States.

The SSM Regulation imposes certain tasks on the SSM among which ensuring compliance of credit institutions with "EU banking rules" is expressly included. In addition, the SSM is tasked with an explicit duty to:

"carry out ***supervisory reviews****, including where appropriate in coordination with EBA, stress tests and their possible publication, in order* ***to determine whether the arrangements, strategies, processes and mechanisms put in place by credit institutions and the own funds held by these institutions ensure a sound management and coverage of their risks****, and on the basis of that supervisory review to impose on credit institutions specific additional own funds requirements, specific publication requirements, specific liquidity requirements and other measures, where specifically made available to competent authorities by relevant Union law".*

Covered bonds have significant implications for the prudential soundness and orderly resolution of credit institutions, in particular as major contributors to a credit institution's asset encumbrance and, accordingly, the SSM takes into account covered bond issuance in the performance of their tasks. However, the SSM is not responsible for the special supervision of covered bond issuers and cover pools, which remain an exclusive domain of national competent authorities (either the banking or the markets authority) in accordance with their national laws.

Against the backdrop of the SSM's supervisory review duties and more broadly the objectives of Banking Union, it would seem appropriate to consider whether ECB should have a more specific supervisory role on the special supervision and monitoring of covered bond issuance by credit institutions falling within the scope of the SSM.

QUESTION – COVERED BONDS AND THE SSM

Should the ECB have specific supervisory powers, and if so which ones, in relation to covered bond issuance of credit institutions falling within the scope of the SSM?

3. DUAL RECOURSE AND INSOLVENCY/RESOLUTION REGIME

3.1 Definition of dual recourse principle

The dual recourse principle is enshrined in Article 52(4) of the UCITS Directive and constitutes one of the key features of covered bond legislation in the EU. In reflecting the same principle, the Framework could provide that “regulated” covered bonds must grant the bondholder:

- a direct claim against the cover pool on an absolute priority basis upon default of the issuer. "Absolute priority basis" means that the proceeds from the cover pool must be

applied to repay principal and interests due to bondholders in priority to all other creditors of the issuer. The issuer's default may be triggered upon its resolution or declaration of insolvency; and

- a full recourse claim against the issuer for the timely repayment of principal and payment of interests attached to the covered bonds. “Full recourse” means that bondholders must be entitled to the proceeds from the liquidation of the issuer's insolvent estate as "unsecured creditors" for any deficit that may result from applying the proceeds of the cover pool to meet all liabilities due to them on an absolute priority basis as set out above.

Key to the effective implementation of the dual recourse principle is a robust insolvency and resolution regime that ensures the segregation of the cover assets upon insolvency/resolution of the issuer and the on-going administration of the cover pool. The Framework would seek to implement the best practice principles advocated by the EBA Report on both asset segregation and insolvency remoteness as discussed below.

QUESTION – DUAL RECOURSE PRINCIPLE

Do you agree with the proposed formulation for "dual recourse"?

3.2 Segregation of the cover assets

Consistent with a majority of Member States’ covered bond laws, the Framework could provide for a clear and effective mechanism to identify cover assets at pre-insolvency/resolution stage by requiring issuers to maintain a register of cover assets. Further consideration should be given to the possibility of using SPVs as an additional segregation mechanism, as currently required in some Member States' laws. The form and content of the asset register could be harmonised through primary or secondary legislation or EBA/ESMA supervisory guidelines. Further, as recommended by the EBA, the segregation should encompass all primary assets, substitution assets and derivatives entered into to hedge risks arising from the covered bond programme.

It may also be desirable for the Framework to impose an obligation on the issuer to have a detailed plan in place setting out operational procedures that ensure the orderly segregation and on-going operation of the cover pool as an independent entity upon the issuer's insolvency/resolution. In particular, the issuer should be required to keep loan documentation up-to-date and readily accessible for the cover pool administrator to be able to take over management of the pool and enforce any connected rights and security.

QUESTIONS – SEGREGATION OF THE COVER ASSETS

1. **Are there any advantages to using an SPV as an additional segregation mechanism at issuance? Are cover assets typically transferred to the SPV at issuance via legal or equitable assignment?**
2. **In your jurisdiction, what legal and practical steps are required in order to segregate effectively the cover assets from the issuer's insolvent estate or in**

resolution? Would it be necessary to serve a notification to each borrower of the issuer? Until notification is served, what is the legal status of any proceeds of the cover assets which may be paid directly into the insolvent estate or to the issuer in resolution?

3.3 Administration of the cover pool post insolvency/resolution of the issuer

Following the segregation of the cover pool, this must be administered as a separate entity with a view to fulfilling the payment obligations towards the bondholders and other counterparties. Consistent with the best practice principles advocated by the EBA Report, the Framework could apply the following provisions with regard to the administration of the cover pool:

– legal form and supervision of the cover pool: it may be appropriate to require the cover pool to be incorporated as a regulated entity, as currently required by the covered bond laws of some Member States, in order to place the cover pool and its administrator under public supervision.

QUESTIONS – LEGAL FORM AND SUPERVISION OF THE COVER POOL

1. **Should the cover pool be incorporated as a regulated entity? In that case, what type?**
2. **Who should be the supervisory authority for these purposes, the competent authority or the resolution authority?**

– appointment and duties of the special administrator: the on-going management of the cover pool should be subject to special administration. The Framework could specify the following set of requirements in relation to the special administrator of the cover pool:

  a) eligibility requirements: the special administrator should be an officer of the court and, accordingly, only those that may act as insolvency practitioners in each Member State would be eligible to be appointed;

  b) power to appoint and remove: the special administrator should be appointed by and accountable to the insolvency court. However, the competent authority or the resolution authority should be given a role in the appointment process (for instance, right to be heard or right of initiative to put forward candidates to the court for appointment);

  c) duties and powers: the special administrator's primary duty should be to act in the interests of the bondholders as a whole and should perform his or her

functions with the overriding objective of settling in full the liabilities of the cover pool. The special administrator should be given a range of powers which are adequate and sufficient to carry out his or her primary duty and overriding objective; and

d) liquidator of the issuer: where national covered bond laws provide for the liquidator of the issuer to act at the same time as administrator of the cover pool, the above should apply to the liquidator in its role as special administrator.

QUESTIONS – SPECIAL ADMINISTRATOR OF THE COVER POOL

1. **What are your views on the proposals set out in subsection 3.3 of Part III on the appointment and legal regime for a cover pool special administrator?**
2. **Should the special administrator be obliged to report regularly to the relevant supervisory authority? Should the content and regulatory of such reporting be the same as for the issuer?**

– ranking of cover pool liabilities: the bondholders should continue to benefit from a priority claim on the proceeds of the cover pool, both during the on-going operation of the cover pool as an independent entity and at the time it is wound up. However, the Framework could permit to give absolute priority (thus ranking ahead of the bondholders) to any expenses properly incurred by the special administrator or the liquidator in connection with the cover pool, in which case the nature of such claims and when they could be considered adequate may have to be defined. Further, the claims of the following creditors of the cover pool could be allowed to rank *pari passu* with the claims of the bondholders:

a) persons providing services to the cover pool;

b) counterparties to hedging instruments which may be incidental to the maintenance and administration of the cover pool or to the terms of the covered bonds; and

c) persons (other than the issuer) providing a loan to the cover pool to enable it to satisfy the claims of any of the above persons.

QUESTIONS – RANKING OF COVER POOL LIABILITIES

1. **Do you agree with the suggested ranking for cover pool liabilities? Is the wording proposed in subsection 3.3 of Part III sufficient to define clearly the claims that may arise, avoid confusion between claims and prevent claims in an unreasonable amount from arising?**
2. **Is it possible to define hedging activity better and, if so, how?**

3.4 Interaction between cover pool and issuer in insolvency/resolution

As a result of the operation of the dual recourse mechanism, the cover pool may need to continue interacting with the insolvent estate and/or the successor credit institution following respectively the issuer's insolvency or resolution under two possible scenarios:

- where settlement of the covered bonds in full delivers excess collateral, this must be returned to the successor credit institution or the insolvent estate, as the case may be; or

- where covered bonds cannot be settled in full with the cover assets alone, bondholders will have a residual claim as unsecured creditors against the insolvent estate and/or the successor credit institution.

However, the cover bonds and the successor credit institution or estate may not have the same life expectancy, which may give rise to uncertainty of outcomes for both bondholders and the remaining creditors of the issuer. For instance, the long maturity of the cover bonds may lead to protracted resolution and insolvency proceedings during which the successor credit institution and/or insolvent estate remain liable for possible residual claims from the bondholders.

Finality could be provided with a clear cut-off mechanism that would release the insolvent estate and/or successor credit institution from possible residual claims after a given date and provided that adequate protections for bondholders were put in place.

In addition, the Framework could lay down an explicit role with clear powers and duties on resolution authorities as part of a cut-off mechanism for covered bonds. For instance, resolution authorities could be given express powers to set a maximum level of permitted overcollateralisation ("**OC**") either in the on-going life of covered bond transactions or at the time of resolution or insolvency of the issuer or to appoint a valuer for the cover pool.

QUESTIONS – INTERACTION BETWEEN COVER POOL AND ISSUER IN INSOLVENCY/RESOLUTION

1. **Are current provisions in EU law sufficient to deliver effective protection for boldholders in a resolution scenario involving covered bonds? In particular, is it sufficiently clear:**

   a) **how the cover pool would be segregated under each possible resolution or recovery scenario of the issuer?**

   b) **how the full recourse against the issuer would take effect if the issuer is in resolution and is not placed subsequently into liquidation?**

   c) **what procedural steps should be followed in resolution and by whom in order to make effective the dual recourse mechanism?**

2. **Should the Framework provide for a cut-off mechanism as suggested in subsection 3.4 of Part III? In particular, should such a cut-off mechanism:**

a) **preclude the closure of insolvency or resolution before possible residual claims from the covered bondholders against the issuer or the insolvent estate have been identified and quantified?**

b) **set out clear and objective requirements on the valuation of the cover pool and the timing for such valuation?**

c) **extinguish the residual claim on the estate or the successor credit institutions after sufficient assets have been segregated for the benefit of covered bondholders at the outset of the resolution or insolvency proceedings?**

d) **give specific powers and duties to the resolution authority and, if so, what should those consist in?**

4. THE COVER POOL

As set out in the EBA Report, the features of the cover pool affect the performance of covered bonds and, ultimately, the risk that both interest and principal payment obligations may not be fulfilled as they become due. In particular, the Report highlights the following as main cover pool-related risks: (i) the credit risk associated with the underlying obligors; (ii) the recovery capacity associated with the loans; (iii) concentration risks at geographical, asset-class, individual underlying obligor or financial sector-specific levels; (iv) market and liquidity risks of the underlying assets following the issuer's default; (v) the type of security over the underlying assets and their collateralisation mechanism, including the enforceability of the security over the underlying assets; and (vi) the quality and quantity of substitution assets in the cover pool.

All covered bond laws of Member States address the above risks to different degrees with specific provisions on the nature and characteristics of the cover pool and its management by the issuer. This section outlines various similar provisions that could be proposed to the same end as part of the Framework. Insofar as practicable, the Framework would attempt to find common ground between the laws of Member States in this area while at the same time applying the best practice principles advocated by the EBA.

As pointed out in subsection 1.2 of this Part, the provisions in the Framework dealing with the cover pool would be used as new criteria for the assignment of preferential risk weights and, accordingly, these would replace the equivalent high level criteria set out in Article 129 of the CRR.

4.1 Eligible assets: qualifying criteria and requirements

- ***Residential and commercial loans***

  The Framework could allow both residential and commercial loans as eligible assets for cover pool purposes, provided that they meet certain minimum eligibility criteria as described below:

– definition and legal requirements: "residential and commercial loans" as an asset class would include two subcategories of assets:

  a) mortgage loans granted to a borrower for residential or commercial purposes where the borrower's obligation to repay principal and pay interests are secured for the benefit of the lender by a security or lien on the property. Mortgage loans would be subject to the following legal requirements:

    i) perfection of security: the mortgage should be legally valid and enforceable against the borrower in accordance with the applicable law at the time the loan is added to the cover pool;

    ii) first ranking: the mortgage should be a "first ranking mortgage", although this requirement should be defined taking into account certain charges or encumbrances with an explicit priority in law or in statute (eg levies on the property);

  b) in France, guaranteed residential loans meeting the qualifying criteria set out in Article 129(1)(e). As recommended by the EBA, these loans could be subject to an additional requirement that the law governing the covered bonds should not preclude the administrator of the cover pool from creating mortgages over the loans included in the cover pool where the guarantee, for any reasons, has ceased to exist following the issuer's default;

– loan-to-value (LTV) ratio(s) and valuation requirements: residential and commercial loans should be subject to specific maximum LTV ratios, defined as a limit on the principal of the loan relative to the value of the property. As shown in the EBA Report (see Table 13), the covered bond laws of Member States apply LTV ratios of different types and subject to varying criteria and limits. However, common features to a majority of laws which the Framework could seek to apply would include:

  a) a distinction between, at least, residential and commercial loans to set different LTV limits (more conservative for the latter);

  b) setting LTV limits for the calculation of collateralisation coverage levels and, in some cases, for the eligibility of individual loans as well;

  c) a requirement that LTV levels apply for the entire lifetime of the covered bonds;

  d) a further requirement that LTV levels be measured on a specified property value (either "market value", "mortgage lending value" or variants thereof) and updated regularly;

  e) a recognition of privilege for any excess over the LTV cap, in accordance with which covered bondholders will be entitled to that excess on a priority basis in the event of liquidation of the cover pool.

  As advocated by the EBA, the valuation of the properties should be based on transparent valuation rules and be carried out by a valuer that is independent from the credit granting process;

– location of assets: as a general principle, cover pools should be permitted to comprise residential and commercial loans secured by properties located in any Member State of the European Union and the European Economic Area and with no jurisdiction-based limits. Residential and commercial mortgage loans in third countries should be allowed in the cover pool where they are located in jurisdictions assessed as "equivalent third countries" (see subsection 1.3 of this Part);

– non-performing loans should be completely excluded from the cover pool. This would exclude loans that were non-performing at the time of issuance and loans that become non-performing at any time after issuance which the issuer would be obliged to replace in the cover pool.

In relation to mortgage-backed securities (RMBSs and CMBSs), the EBA Report notes that a handful of Member States covered bond laws allow for the inclusion of senior tranches of RMBSs and/or CMBSs in cover pools under various conditions. However, in making a recommendation on whether the CRR should retain the derogation provided for in Article 496 of the CRR, the EBA expresses overarching prudential concerns on the use of RMBSs or CMBSs as cover assets in excess of the 10% threshold as currently permitted by that Article and, accordingly, suggests removing the derogation after 31 December 2017. EBA's concerns are mainly due to: (i) the added legal and operational complexity resulting from the double layer structure provided by the covered bonds and the tranche of securitisation instruments backing those; (ii) the potential for conflicts of interest that may arise as a result of the provision in the derogation in Article 496 requiring a member of the covered bond issuer's group to retain the whole first loss securitisation tranche backing the senior securitisation tranches in the event of issuer's default; and (iii) potential conflicting requirements on transparency and due diligence between the covered bond programme and the underlying securitisation instruments.

QUESTIONS – RESIDENTIAL AND COMMERCIAL LOANS

1. **Do you agree with the proposed definitions for "residential" and commercial loans" as cover assets? Should certain riskier residential or commercial loans (ie buy-to-let mortgages; second home loans; loans to real estate developers; etc.) be excluded from the cover pool or permitted subject to stricter criteria?**

2. **In relation to mortgage loans:**

   a) **what are your views on the proposed requirements on "perfection of security" and "first ranking mortgage"? Is registration of the security a requirement for perfection in your jurisdiction?**

   b) **is the enforceability of mortgages in the different Member States equivalent or should there be additional requirements to ensure their equivalence?**

   c) **are minimum standards for mortgage rights in third countries necessary?**

3. **In relation to LTVs:**

   a) **what are your views on the proposals set out in subsection 4.1 of Part III on minimum LTVs?**

b) **in the case of insured properties, should higher LTV limits be allowed if the insurance cover meets certain requirements and, if so, what should such requirements be? In what other cases should higher LTV limits be allowed? Could loan-to-income requirements be used to replace or complement LTV limits?**

c) **should there be an additional average LTV eligibility limit at portfolio level?**

d) **with the advent of a Binding Technical Standard defining Mortgage Lending Value, is it appropriate to apply this for eligibility in all cover pools across the Union as a prudent measurement?**

e) **should LTV limits be used to determine: eligibility (loan in/out) of loans at inception? Eligibility (loan in/out) of loans on an ongoing basis? Should they instead be used to simply determine contribution to coverage? A combination of the above?**

4. **In relation to the valuation of cover assets:**

a) **how frequently should the value be updated and in which way (revaluation, update of the initial valuation, and in which way)?**

b) **what criteria should be applied to (i) the valuer and (ii) the valuation process to ensure that they meet the transparency and independence principles set out in the first and second subparagraphs of Article 229(1) CRR?**

5. **Should the Framework adopt the definition of "non-peforming exposures" as set out in the EBA's draft Implementing Technical Standards on Supervisory Reporting on Forbearance and Non-performing Exposures[8]?**

6. **In light of the EBA's prudential concerns in relation to the use of RMBSs and/or CMBSs in cover pools, should the Framework exclude these assets completely from qualifying as cover assets (including, for these purposes, as substitution assets) or should they be allowed only subject to strict criteria and within the 10% limit currently permitted under Article 129 of the CRR? What is the added value and practical uses of RMBS/CMBS as collateral in your jurisdiction/issuer?**

- ***Public sector loans***

As permitted by a majority of Member States covered bond laws, the Framework would allow public sector loans in Member States of the Union and the EEA as cover assets and these should not be subject to any jurisdiction-based limit. Eligible public sector loans would include loans to or exposures guaranteed by the following:

[8] https://www.eba.europa.eu/documents/10180/449824/EBA-ITS-2013-03+Final+draft+ITS+on+Forbearance+and+Non-performing+exposures.pdf/a55b9933-be43-4cae-b872-9184c90135b9

– any central government and central bank of Member States of the EU and the EEA; and

– regional governments, local authorities and public sector entities within Union and EEA Member States, provided that exposures to those are treated as exposures to their central governments in accordance with Articles 115 and 116 of the CRR or, otherwise, they meet other qualifying criteria such as a minimum external rating or credit quality step.

Loans to and exposures guaranteed by central governments, central banks, regional governments, local authorities or public sector entities in third countries and certain international organisations would also be allowed as cover assets provided that following requirements were met:

– the third country has been assessed as an "equivalent third country" (see subsection 1.3 of this Part);

– the loans meet in each case the requirements set out in Article 129 of the CRR; and

– the loans fall within the limits for mixed pools (see below subsection on mixed pools).

QUESTIONS – PUBLIC SECTOR LOANS

1. **What are your views on the proposals for public sector loans as cover assets set out in subsection 4.1 of Part III?**

2. **What eligibility requirements in terms of validity and enforceability should apply to the guarantee granted by the relevant public sector entity?**

- ***Other assets: Aircraft, Ship and SME loans***

The EBA Report notes that only the covered bond laws of Luxembourg and Germany allow aircraft loans as cover assets, whilst this type of covered bonds is not included within the scope of Article 129 of the CRR. In its technical advice to the Commission in accordance with Article 503(3) of the CRR, the EBA expresses prudential concerns on the potential inclusion of aircraft loan-backed covered bonds within the scope of the preferential risk weight treatment, in particular due to: (i) lack of sufficient and reliable public historical evidence over default and loss behaviour of aircraft loans; (ii) volatility and pro-cyclicality of the aircraft value; (iii) complexity of the aircraft valuation process; (iv) limited number of lenders in the aircraft finance sector and issuers of these covered bonds; and (v) specific legal issues such as the limited mutual recognition of the security over the aircraft between jurisdictions.

Although EBA's opinion is expressed for preferential risk weight purposes, it casts doubts more generally on the adequacy of aircraft loans to qualify as cover assets given the stated objective of developing a Framework of "regulated covered bonds" based on high standards and best practices. Some of these concerns could be raised in relation to other assets such as ship loans and loans to SMEs.

QUESTIONS – OTHER ASSET CLASSES: AIRCRAFT, SHIP AND SME LOANS

1. **Should the Framework exclude aircraft, ship and SME loans from cover pools or should they be allowed only subject to strict criteria and limits? If so, what criteria**

and limits should be applied?

2. **In relation to SME loans, is it possible to identify a category of "prime" SME loans as a potential eligible asset class for cover pools?**

- ***Mixed pools and limits on exposures***

A majority of Member States' covered bond laws allows for more than one asset class in the cover pool, although some laws may impose specific limits on certain types of assets within the pool. The EBA report recommends setting regulatory limits on the composition of mortgage pools as a means of maintaining the risk profile of the cover pool throughout the life of the transaction. However, the EBA also acknowledged in its Report that "other tools may equally ensure consistency and stability in the composition of mixed pools, including contractual arrangements (…) and the supervision on the composition of mixed pools based on supervisory guidelines".

It seems appropriate to allow generally mixed-asset cover pools as a useful instrument to mitigate concentration risk within the pool and provided that adequately conservative valuation and LTV criteria are followed (as per above). However, limits on certain specific cases could be considered, for instance:

- assets representing exposures to credit institutions and investment firms should be limited to 15% of the nominal amount of outstanding covered bonds consistent with Article 129(1)(c) of the CRR;

- similarly, exposures to public sector loans in third countries should be limited to 20% of the nominal amount of outstanding covered bonds consistent with Article 129(1)(b) of the CRR. Specific limits could be applied as well to mortgage assets with properties located in third countries;

- in France, the 35% limit on guaranteed loans for *obligations foncières* should continue to apply; and

- a concentration limit at the level of the individual obligor's name in the underlying exposures and exposures to credit institutions could also be considered.

QUESTIONS – MIXED POOLS AND LIMITS ON EXPOSURES

1. **Do you agree that mixed-asset cover pools should be allowed?**

2. **What are your views on the proposed limits on specific assets and concentration of exposures? Should any other limits or requirements apply?**

4.2 Coverage requirement and overcollateralisation

The "coverage requirement" underpins all the covered bond laws of Member States insofar as those implement the principle set out in Article 52(4) of the UCITS Directive. This Article provides that "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 covering

claims attaching to the bonds and which, in the event of failure of the issuer, would be used on a priority basis for the reimbursement of principal and payment of the accrued interest". The requirement is, however, implemented differently across Member States, with the EBA Report describing three possible formulations either as:

- nominal coverage: the nominal amount of all cover assets must be at all times at least as high as the nominal amount of outstanding covered bonds; or

- net-present value coverage: the net present value of the cover assets must be at all times at least as high as the net present value of all outstanding covered bonds, which involves using a yield curve to discount future cash flows; or

- net-present value coverage under-stress: same as the preceding but with the added requirement that the coverage must hold even following the implementation of yield curve stress tests, currency tests and other forms of stress tests mandated by the law or regulations. The EBA reports that covered bond laws of Member States using this formulation apply different stress test requirements, some simply stating the obligation to conduct stresses on the covered bonds and cover assets, while some others prescribed detailed features for such stress tests.

The Framework could at least reformulate the coverage requirement to include explicit coverage over all liabilities of the covered bond programme as recommended by the EBA, thus including both the liabilities towards bondholders and other parties involved in the process of covered bond issuance and management such as counterparties in derivative contracts, managers, administrators, servicers, trustees, the cover pool monitor and any other relevant parties. It may also be desirable for the Framework to define the coverage requirement in more precisely quantified terms in accordance with, at a minimum, one of the three options outlined above.

QUESTIONS – COVERAGE REQUIREMENT

1. **Which option should be preferred for the Framework to formulate the coverage requirement and why?**

    a) **a general requirement along the lines of Article 52(4) of the UCITS Directive, amended to include the wording suggested by the EBA;**

    b) **a nominal coverage;**

    c) **a net-present value coverage;**

    d) **a net-present value coverage under stress; or**

    e) **any other or a combination of the some or all of the above.**

2. **If the coverage requirement were formulated as net-present value coverage under stress, should the stress tests be specified in any form in the Framework or ESMA/EBA regulatory guidelines? If so, what specific stress tests should be required and why?**

3. **Should derivatives entered into in relation to the cover pool be taken into account**

for the purpose of determining the coverage requirement? If so, what valuation metric should be used for these purposes?

4. **What exposures to credit institutions within the pool should be taken into account to determine the coverage requirement and why?**

The EBA also notes the lack of consistency between the covered bond laws of Member States in setting a minimum level of OC ranging from the absence of such requirement to values above 40%. Against this backdrop, the EBA recommends setting a "quantitative legal/regulatory minimum over-collateralisation level" as a best practice to safeguard the credit quality of the covered bonds, noting the need to carry out further analysis on a number of intervening factors (including, for example, whether there should be different levels depending on the cover asset class or the interaction with the chosen definition of coverage requirement).

Higher levels of voluntary OC increase asset encumbrance in the issuer's balance sheet and, therefore, may detriment unsecured creditors in resolution and insolvency. As explained in subsection 3.4 of this Part, it may be appropriate to impose limits on the maximum levels of OC that should be permitted either in the ongoing life of covered bond transactions, in resolution/insolvency of the issuer or both in order to provide cut-off to both bondholders and the remaining creditors of the issuer.

The OC level would be calculated on the same basis as the coverage requirement where the latter is formulated in accordance with one of the precisely quantified options outlined above. The duties of the cover pool monitor as referred to in subsection 2.2 of this Part would include monitoring compliance with the mandatory OC level requirement and reporting it to the competent authority.

QUESTIONS – OVERCOLLATERALISATION

1. **Should a quantitative mandatory minimum OC level be set in the Framework? If so, what should that level be and should it be the same for all types of covered bonds?**

2. **If a mandatory minimum OC level were set in the Framework, should there be exceptions to the requirement? (for example where the issuer applies a precise "match funding model" or where certain targeted liquidity and market risk mitigation measures are used – see subsection 4.3 of Part III)**

3. **Should the Framework set a maximum level of permitted OC? If so, when and at what level?**

4. **Should the Framework provide for the treatment of voluntary OC in the event of insolvency/resolution of the issuer?**

4.3 Cover assets/liabilities risk mitigation: market and liquidity risks

The EBA notes in its Report that OC levels, both baseline and under stress when coupled with the coverage principle of net present value under stress, are the "main mitigation tool for most risks arising in covered bond programmes, including interest rate risk".

In addition to mandatory minimum OC levels, careful consideration should be given to the opportunity of imposing targeted market and liquidity risk mitigation requirements as set out in this subsection.

- ***Use of hedges***

  The Framework could include an explicit obligation on issuers to hedge interest rate risk and currency risk in the cover pool and the following limits on the use of hedges consistent with the recommendations set out in the EBA Report:

  - limit on the use of derivative contracts: the use of such contracts in covered bond programmes may be allowed only for risk hedging purposes;

  - limit on the eligibility of derivatives' counterparties: the covered bond issuer may only enter into derivatives with a narrowly defined set of counterparties (i.e. on the basis of rating and/or legal status);

  - prohibition of intra-group hedging;

  - requirement that derivatives continue following the insolvency or resolution of the issuer; and

  - preclude the priority of derivatives' counterparties' claims, which are only allowed to rank *pari passu* at best with the claims of covered bondholders (this item was discussed in subsection 3.3 of this Part).

- ***Management of cashflow mismatches***

  The Framework could set out specific provisions to prevent or manage potential mismatches between the timing of cashflows on the cover assets and those of the covered bonds following segregation of the pool from the issuer. Potential provisions to that end as recommended by the EBA Report could include:

  - an explicit ban on the acceleration of the payment obligations attached to the covered bonds upon insolvency or resolution of the issuer, as currently required by most Member States' covered bond laws. This ban could be supplemented with an explicit power for the special administrator to implement "structural mitigants" of liquidity risk such as soft bullets or conditional pass-through structures as described in the Report;

  - a requirement on issuers to hold a buffer of liquid assets calibrated "to cover the cumulative net out-flows of the covered bond programme over a certain time frame";

  - a requirement on the issuer and the special administrator to conduct liquidity tests within a given timeframe ahead of principal or interest payment maturity; and

– special exceptions for fully matched funding structures, where the maturity and interest rate features of the covered bonds match those of the cover assets.

The requirement to hold a buffer of liquid assets in particular should be the subject of further analysis, both as regards its calibration and scope, as noted by the EBA, and also the manner in which it could interact with other liquidity mitigation requirements.

QUESTIONS – MARKET AND LIQUIDITY RISKS

1. **In your view, are OC levels adequate to mitigate market and liquidity risks in the absence of targeted measures such as those described in subsection 4.3 of Part III?**

2. **Should the Framework lay down specific requirements on the use of derivatives as suggested in subsection 4,3 of Part III? How should "eligible counterparties" be defined for the purposes of entering into permitted derivatives?**

3. **What are your views on the potential provisions on the management of cashflow mismatches suggested in subsection 4.3 of Part III? In particular:**

   a) **for issuers, do cashflow mismatches between cover assets and covered bonds arise in your jurisdiction and/or transactions, and, if so, in which way? Are you able to describe a scenario for the timely repayment of the covered bonds? Do you plan for contingencies? Are such scenarios and contingencies disclosed to investors?**

   b) **for investors, do you understand how such cashflow mismatches would be dealt with in practice? Would it be beneficial from your perspective to get systematic information about cashflow mismatches and how these would be managed?**

4. **On the EBA's liquidity buffer recommendation:**

   a) **should covered bond issuers hold a "liquidity buffer" to mitigate liquidity risk in the cover pool and, if so, in what circumstances?**

   b) **should the buffer be calibrated to cover the cumulative net out-flows of the covered bond programme over a certain time frame? What length of time should be used as a time frame for calibration purposes?**

   c) **what eligibility criteria should liquid/substitution assets meet to qualify for the purposes of this buffer?**

5. TRANSPARENCY REQUIREMENTS

Transparency towards investors refers to the information on the cover bonds, the cover assets and the issuer that investors receive at issuance and thereafter on an on-going basis to carry out their own risk analysis on the covered bonds. The EBA Report notes that transparency and disclosure practices and requirements in European covered bonds are

highly fragmented and inconsistent due to various factors, notably the differences in issuer models, types of cover assets and national legal and regulatory frameworks.

From an EU law perspective, issuers of covered bonds are subject to the disclosure requirements in Directive 2003/71/EC (the "**Prospectus Directive**") and Regulation (EC) No 809/2004 (the "**Prospectus Regulation**"). Under these legal instruments, information must be made available on the issuer itself and debt securities issued by it, but unlike in the case of asset-backed securities there are no provisions in them dealing with covered bonds as distinct debt securities or with their cover assets. Furthermore, the Prospectus Directive and Regulation apply to public offers of securities and admission to trading on regulated markets. Since, as seen in Part I, a significant segment of the covered bond market is placed with investors through private placement and not through public offers and are also subsequently not listed, this segment would be typically outside the scope of the prospectus regime.

A specific disclosure provision is included in paragraph 7 of Article 129 of the CRR which lays down certain minimum disclosure standards and a semi-annual disclosure regularity as conditions for the credit institution investing in the covered bonds to benefit from the "preferential risk weights" set out in that Article. Under this provision, the issuer must make available information on:

– the value of the cover pool and outstanding covered bonds;

– the geographical distribution and type of cover assets;

– loan size, interest rate and currency risk;

– the maturity structure of the cover assets and covered bonds; and

– the percentage of loans more than 90 days past due.

EBA notes "investors' uncertainty about the compliance of certain covered bond programmes with Article 129 of the CRR" as this provision "may leave excessive room for interpretation for both issuers and competent authorities". Against this background, the EBA recommended in its Report that a legal/regulatory covered bond framework "require covered bond issuers to disclose data on the credit risk, market risk and liquidity risk characteristics of the cover assets and the covered bonds of a given programme (…) to a level of detail enabling investors to carry out a comprehensive risk analysis". Furthermore, EBA recommended that the disclosure to investors currently required under Article 129(7) of the CRR should "occur at least on a quarterly basis"

As described in the EBA Report, private-led initiatives have attempted to fill this regulatory loophole with detailed investor reporting templates. Both the International Capital Markets Association's ("**ICMA**") Reporting Template and ECBC's National Transparency Templates constitute very positive initiatives insofar as they provide investors with more granular and better-suited information on covered bond programmes' liabilities and cover assets. However, having analysed the latter the EBA noted a number of challenges, for instance:

– the National Transparency Templates differ substantially across jurisdictions, partly due to the factors identified above and, notably, the lack of harmonisation between national covered bond laws;

- not all Templates seem to align with the disclosure standards set out in Article 129 of the CRR; and
- in any event, the Templates are of voluntary adoption by issuers and, accordingly, do not cover the entire market.

It is worth noting the ECBC's ongoing work to develop a "Common Harmonised Template" for all covered bond issuers holding the Covered Bond Label and which, therefore, will apply on a cross-border basis, thus potentially addressing the disparity between the National Transparency Templates. The ECBC announced that the Harmonised Template will start to apply from first quarter of 2016 with a phase-in period of one year.

QUESTIONS – TRANSPARENCY REQUIREMENTS

1. **What are your views on the current disclosure requirements set out in Article 129(7) of the CRR? If more detailed requirements were preferred, do you agree that issuers should disclose data on the credit, market and liquidity risk characteristics to a more granular level? If so, what data and to what level of granularity?**
2. **Should issuers disclose information on the counterparties involved in a covered bond programme and, if so, what type of information?**
3. **How frequently should covered bond issuers be required to make disclosures to investors?**
4. **What are your views on the existing and prospective investor reporting templates prepared by industry bodies and referred to in section 5 of Part III? Would these templates:**
    a. **be granular enough to enable investors to carry out a comprehensive risk analysis as recommended by the EBA? and**
    b. **be sufficient without further legislative backing to deliver enhanced and consistent disclosure in European covered bond markets?**
5. **Should detailed disclosure requirements apply to all European covered bonds or only to those that would fall within the scope of the Prospectus regime?**
6. **Should the same level of disclosure standards apply pre- and post-insolvency/resolution of the issuer (except for those reporting items referring to the issuer itself)?**
7. **In relation to covered bonds issued in third countries, what minimum level of disclosure should apply for European credit institutions investing in those instruments to benefit from preferential risk weights?**