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Capital Markets Union - Part 3: Proposed Elements of a New EU Covered Bond Framework

An EU-wide dedicated legislative framework for covered bonds is one of the options currently being considered as part of the European Commission's consultation on covered bonds. This option, according to the Commission's consultation document (the Consultation Paper), would regulate covered bonds as a legal instrument, rather than just their prudential treatment.

This update (the third in our series of updates on the Capital Markets Union), summarises the Commission's high-level design for a hypothetical EU covered bonds framework. The proposed elements of the new framework are drawn from the European Banking Authority's (EBA) "Report on EU Covered Bond Frameworks and Capital Treatment" (the EBA Report). Certain key areas are identified as the elements necessary for a robust covered bond framework, as referred to in our previous update on covered bonds.¹ These are discussed in further detail below.

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The Covered Bond Definition

The Commission notes in the Consultation Paper that there is no formal, widely accepted definition of "covered bonds". EU legislation,² which regulates the prudential treatment of covered bonds, does, however, provide some degree of indirect harmonisation among Member States by defining the features of a covered bond as bonds that fulfil the conditions specified in Article 52(4) of the UCITS Directive. Under these conditions, the bonds must be issued by a credit institution with a registered office in a Member State and which is subject, by law, to special public supervision designed to protect bondholders. Another condition is that the sums derived from the issue of the bonds should be invested in a cover pool of assets that is capable of covering claims attaching to the bonds.

The Commission proposes a single definition for covered bonds that would expand upon the features outlined in Article 52(4) of the UCITS Directive, and provide a way to recognise "equivalent covered bonds" issued by credit institutions with a registered office in a non-EEA country. It is also proposed that any third country covered bond regimes that are assessed as "equivalent" would be published on a list to be maintained and updated on a regular basis by ESMA or the EBA.

Covered Bond Issuers and System of Public Supervision

Noting that existing Member State laws provide for a variety of different covered bond issuer structures, including structures whereby credit institution issuers have established unregulated special purpose vehicles (SPVs), the Commission confirms that an integrated EU framework would seek to recognise all existing issuer models. This would be done, however, in accordance with a unifying set of principles. Provided that a reasonable common ground can be found between legal systems, the Commission also recommends streamlining the myriad of licensing systems for issuers and covered bond programmes across the Member States, and harmonising prudential requirements applicable to covered bond issuers.

¹ Please click [HERE](#) for a link to the previous update: Capital Markets Union – Part 2: Two Options for a Pan-European Covered Bond Framework.

² Article 129 of the Capital Requirements Regulation.

The new framework could also provide for the appointment of an independent third-party monitor of the cover pool; set eligibility criteria in respect of the cover pool; and designate common supervisory duties and powers on competent authorities.

The Consultation Paper also asks whether the European Central Bank (ECB) should have specific supervisory powers in relation to covered bond issuance of credit institutions falling within the scope of the Single Supervisory Mechanism (SSM). The SSM is the name for the mechanism which has granted the ECB the power to monitor the financial stability of banks based in participating states. At present, however, the SSM is not responsible for the supervision of covered bond issuers and cover pools.

The Dual Recourse Principle and Insolvency/Resolution Regime

Any formulation of an integrated EU framework needs to address the existing dual recourse mechanism that is embedded in Article 52(4) of the UCITS Directive: one of the main characteristics of covered bond legislation in the EU, and a significant benefit from an investor's point of view. Any new integrated EU framework would reflect the dual recourse principle, but would be subject to best practice principles recommended by the EBA Report on both asset segregation and insolvency remoteness, as discussed below.

With respect to asset segregation, the Commission proposes to introduce a requirement under the EU integrated framework for issuers to maintain a register of cover assets. Further consideration will be given to the possibility of using SPVs as an additional segregation mechanism, as currently required in some Member States' laws. Once the cover pool has been adequately segregated, it must be structured, administered and supervised appropriately. The Commission asks participants to consider whether the cover pool should be incorporated as a regulated entity, as currently required by the covered bond laws of some Member States, in order to introduce public supervision of the cover pool and its administrator. It is proposed that only insolvency practitioners in each Member State be appointed as special administrators.

On the subject of the ranking of cover pool liabilities, the Commission suggests that the priority claims on the proceeds of the cover pool should continue to be for the benefit of the bondholders, but absolute priority could be given to any expenses incurred by the special administrator or liquidator in connection with the cover pool. The Commission goes further and proposes the possibility of allowing bondholder claims to rank *pari passu* with the claims of other creditors of the cover pool, such as persons providing services to the cover pool; counterparties to hedging instruments which may be incidental to the maintenance of the cover pool or the terms of the covered bonds; and 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.

According to the Commission, any EU integrated framework would need to provide a cut-off mechanism that would release the insolvent estate from residual claims after the issuer has become insolvent or following resolution, while still protecting the bondholders. This would involve granting powers and duties to resolution authorities.

The Cover Pool

Eligible Assets

The eligibility standards with respect to the cover pool, currently the subject of the national laws of the Member States, affect the risks that obligations will not be paid. The new framework could address these risks by including provisions regarding transparency and the cover pool, based on common features to the national laws and the EBA's best practice principles. These provisions could constitute the criteria for the assignment of preferential risk weights. The Commission suggests the following assets could be included in the cover pool:

Residential and commercial loans: as an asset class, they would be divided into two categories, one for first-ranking mortgage loans subject to certain perfection requirements, the second for certain guaranteed residential loans in France, subject to certain conditions.

It is suggested that the residential and commercial loans could be subject to specific maximum loan-to-value (LTV) ratios, with more conservative LTV limits for commercial loans. The LTV limits (that would apply for the lifetime of the covered bonds) could apply with respect to both collateralisation coverage levels as well as the eligibility of individual loans. Loans in jurisdictions assessed as “equivalent third countries” should be allowed in the cover pool.

Reflecting the concerns of the EBA with respect to the use of mortgage-backed securities (CMBSs and RMBSs) in the cover pool, the Commission asks whether the framework should exclude these assets from qualifying as cover assets or merely restrict their use.

Public sector loans: eligible public sector loans could include those guaranteed by any central or regional government, central bank, local authorities and public sector entities from EU/EEA Member States and non-EU/EEA Member States. In the latter case, these loans should be eligible provided the third country is assessed as an “equivalent third country”, the loans meet certain requirements under Article 129 of the Capital Requirements Regulation (CRR) and they fall within the limits for mixed pools.

Further, mixed-asset cover pools would be permitted on the basis that they could mitigate concentration risk within the pool, provided that adequately conservative valuation and LTV criteria are applied. Regarding other assets in the cover pool, the EBA has questioned the exclusion of aircraft, ship and SME loans from the cover pool.

The “coverage requirement” and over-collateralisation

Article 52(4) of the UCITS Directive provides the basis for the “coverage requirement” for covered bonds in Europe: the cover pool should always be capable of covering claims attached to the covered bonds. However, Member States do not consistently implement the coverage requirement. The Consultation Paper cross-refers to the EBA Report, which describes three cover requirement formulations implemented across Member States (“nominal coverage”, “net-present value coverage” and “net-present value coverage under stress”). Given this inconsistency, and further lack of consistency among the laws of Member States in setting a minimum over-collateralisation level, the EBA suggests that the coverage requirement should be defined and the over-collateralisation level set. The Commission seeks views as to preferred options to formulate the coverage requirements.

Market and liquidity risk requirements

The Consultation Paper additionally suggests imposing targeted market and liquidity risk mitigation requirements. These could include, for example, obliging issuers to hedge interest rate and currency risk in the cover pool. In addition, the framework could, among other options, restrict the use of certain hedges within the cover pool, prohibit intra-group hedging, or prevent the priority of derivatives’ counterparties claims.

The framework could also usefully regulate cashflow mismatches by including specific provisions with regard, for example, to the holding of buffers of liquid assets, the conduct of liquidity tests, or an explicit ban on the acceleration of payment obligations attached to the covered bonds upon insolvency or resolution of the issuer.

Transparency requirements

Regarding transparency requirements, the Consultation Paper does not make any specific proposal. It predominantly requests views on the current disclosure requirements set out in Article 129(7) of the CRR. It also asks participants to the consultation if they agree with the findings in the EBA Report on transparency and disclosure.

The EBA Report discusses the highly fragmented nature of the transparency and disclosure practices and requirements in European covered bonds. It also discusses the Prospectus Directive and the Prospectus Regulation, neither of which contain provisions dealing specifically with covered bonds or their cover assets nor consider private placements of covered bonds. According to the EBA, private-led initiatives to develop templates that could provide investors with more information have failed to provide a market-standard solution, although the ECBC’s efforts to develop a “Common Harmonised Template” for certain covered bonds might be more successful. The EBA recommends a framework which would 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. This would allow investors to carry out a comprehensive risk analysis.

Participants to the consultation are invited to reply by 6 January 2016. Ropes & Gray will continue to monitor the debate with stakeholders on the feasibility of greater integration between covered bond laws. If you would like to learn more about the issues in this update, please contact any of the attorneys listed above or your usual Ropes & Gray advisor.