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ALERT

London

November 3, 2015

Capital Markets Union - Part 2: Two Options for a Pan-European Covered Bond Framework

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As part of the European Commission's plan to build a Capital Markets Union (CMU), the Commission has launched a consultation on the possibility of establishing a pan-European covered bond framework. Two policy options for advancing a reform agenda towards integration are outlined in the Commission's consultation document (Consultation Paper) on covered bonds. One option contemplates the voluntary convergence of national covered bond laws, and the other, the introduction of a dedicated EU legislative framework regulating covered bonds as a product.

This reform project will be one of the most significant, and potentially contentious, developments in the history of the covered bond market in Europe. This update, the second in our series of updates on the CMU, outlines the options for reform discussed in the Consultation Paper and the merits of market integration in relation to covered bonds.

The Unique Features of Covered Bonds

Covered bonds provide investors with both the security of a segregated portfolio of collateral as well as recourse to the issuer. They are highly rated and commonly offer an attractive short-to mid-term maturity rate (2-10 years), as well as attractive yields provided by the cashflow on the cover pool (often comprised of high-quality assets such as mortgage loans and public sector debt which conform with certain eligibility criteria).

There have been no defaults since the inception of the market in the 18th century. The dual recourse mechanism gives bondholders direct recourse to a cover pool of high-quality assets as preferred creditors, and a claim against the issuer (or an affiliated entity of the issuer) as ordinary creditors for any residual amounts not fully settled by the liquidation of the cover pool. The safety of covered bonds is further reinforced by the duty of issuers to ensure that the value of the assets in the cover pool always matches, or exceeds, the liabilities in respect of the covered bonds. During the financial crisis, the security and reliability of covered bonds was evident when issuance of covered bonds remained resilient compared to other financial instruments (for example, unsecured debt and asset-backed securities).

Strong Market Performance

Part I of the Consultation Paper summarises and assesses the main, recent market trends in European covered bond markets. It notes that European covered bond markets are one of the largest private debt markets in Europe, having performed strongly since 2003 (with only a decline in issuance in 2013, reflecting general contraction of banks' balance sheets). The strong performance is evidenced by the steady growth in global covered bond issuance, the increase in the geographic scope of the covered bond market and the increase in global covered bonds outstanding (the European market currently exceeds €2.5 trillion).

Existing National Covered Bond Frameworks

Part II of the Consultation Paper considers how the national legal frameworks and supervisory approaches across the Member States that have covered bond legislation differ significantly and have contributed to fragmentation of the covered bond markets along national lines. The national laws relating to covered bonds regulate matters such as credit institution authorisation, supervision, types and qualitative standards of eligible cover assets and disclosure.

Despite this disparity, however, a certain level of harmonisation unifies the covered bond markets in Europe as an indirect result of the prudential treatment of covered bonds under EU law. Covered bonds already benefit from favourable risk weightings and special bankruptcy protection pursuant to the Directive for Undertakings for Collective Investments in Transferable Securities,[1] the Capital Requirements Regulation[2] and the Bank Recovery and Resolution Directive.[3] Nevertheless, the Commission adds that the national laws remain quite different and issuers often have to enhance the product's credit quality in order to make the covered bonds programme adhere to best practice.

Given the sizeable covered bond markets in Europe, some market participants have expressed the concern that implementing a new regime could disrupt an already well-functioning system. While the Commission acknowledges the positive track record of covered bonds, it believes that a more unified framework that introduces common safeguards of robustness and credit quality, and enhanced product definition, would increase the European investor base.

The Reform Agenda and Policy Options

As outlined in Part 1 of our series of briefings on the CMU, the integration of financial markets and services is at the heart of the plan for a CMU and is an essential element for growth and competition in Europe. While the covered bond market in Europe is already strong, the further integration of the European covered bond markets falls within the scope of the plan for a CMU, as fragmentation of the covered bond market is a barrier to an integrated single market for capital.

The "Covered Bond Label" of the European Covered Bond Council has been instrumental in promoting reform of covered bonds. As a market-led initiative, the Commission is concerned that it cannot fully address matters such as public supervision or the insolvency remoteness of the cover pool. If the future of reform involves legislation, then the Commission proposes two contrasting approaches for moving towards an integrated framework for covered bonds:

Option 1: Voluntary convergence of national covered bond laws

This option would leave in place the current covered bond framework, which relies on national laws and prudential treatment at EU level, but would "encourage greater convergence in covered bond laws through voluntary, non-legislative coordinative measures". The Commission would issue recommendations to Member States to implement, in their national legal frameworks, the EBA's best practices in relation to the issuance of covered bonds. In order to encourage Member States to implement the best practices, the Commission feels that it would need to consider strengthening the eligibility criteria of the cover pool assets for the existing preferential treatment under the CRR.

Option 2: EU-wide dedicated legislative framework for covered bonds

This option consists of promoting 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". The Commission highlights "high level elements" that could be the subject of further regulation:

- the definition of covered bond and protection of the term;
- covered bond issuers, supervision, and licensing requirements;
- monitoring or supervision of the cover pool prior to the onset of the issuer's insolvency;
- the dual recourse and insolvency/resolution regime, including the definition of the dual recourse principle;

[1] Directive 2009/65/EC
[2] Regulation (EU) No 575/201
[3] Directive 2014/59/EU

- segregation of the cover pool and its administration and supervision post-insolvency of the issuer;
- eligibility requirements for the cover pool and coverage requirements;
- market and liquidity risk mitigation requirements (e.g., with respect to hedging);
- management of cashflow mismatches; and
- transparency requirements.

The Consultation Paper contemplates the possibility of introducing a new European directive to harmonise the above-mentioned matters in national laws. It is worth noting that the Commission provides for a non-prescriptive approach, where it specifically suggests that the directive might combine high level principles for some matters and detailed requirements with respect to others.

Furthermore, the Commission appears to dismiss the option of introducing a directly applicable regulation that would replace some national laws on covered bonds as "challenging" at this stage "given that covered bond laws are well developed and deeply-rooted in the legal tradition of many Member States."

The Commission also seeks feedback as to whether it is preferable, as a substitute for harmonisation of the above-mentioned matters in national laws, to have an EU law framework for covered bonds. (referred to as a 29th Regime). This regime would allow issuers of covered bonds to turn voluntarily to a separate integrated framework instead of its own national laws, thus providing optionality to both issuers and investors.

Key Proposed Elements of an EU Covered Bond Framework

The Commission seeks feedback as to which option for a pan-European integrated covered bond framework is to be preferred, by 6 January 2016. Building a 29th regime that is designed to work in every Member State, despite the differences in national insolvency, tax, collateral and other relevant regimes, represents a significant task. Part III of the Consultation Paper sets out the key proposed elements for a hypothetical EU law covered bond framework.

The next update in our series of updates on the CMU will discuss some of these key elements in detail and highlight the main questions for stakeholders. If you would like to learn more about the issues in this alert, please contact any of the attorneys listed below or your usual Ropes & Gray advisor.