

## III

*(Preparatory acts)*

## EUROPEAN CENTRAL BANK

## OPINION OF THE EUROPEAN CENTRAL BANK

of 22 August 2018

**on a proposal for a directive of the European Parliament and of the Council on the issue of covered bonds and covered bond public supervision and amending Directive 2009/65/EC and Directive 2014/59/EU; and on a proposal for a regulation of the European Parliament and of the Council on amending Regulation (EU) No 575/2013 as regards exposures in the form of covered bonds**

(CON/2018/37)

(2018/C 382/03)

**Introduction and legal basis**

On 28 March 2018 and 13 April 2018 the European Central Bank (ECB) received requests from the Council of the European Union and the European Parliament respectively for an opinion on (1) a proposal for a directive of the European Parliament and of the Council on the issue of covered bonds and covered bond public supervision and amending Directive 2009/65/EC and Directive 2014/59/EU <sup>(1)</sup> (hereinafter the 'proposed directive') and (2) a proposal for a regulation of the European Parliament and of the Council on amending Regulation (EU) No 575/2013 as regards exposures in the form of covered bonds <sup>(2)</sup> (hereinafter the 'proposed regulation' and, together with the proposed directive, collectively referred to as the 'proposed directive and regulation').

The ECB's competence to deliver an opinion is based on Articles 127(4) and 282(5) of the Treaty on the Functioning of the European Union since the proposed directive and regulation contain provisions affecting (1) the basic task of the European System of Central Banks (ESCB) to define and implement monetary policy pursuant to the first indent of Article 127(2) of the Treaty, (2) the ESCB's contribution to the smooth conduct of policies pursued by the competent authorities relating to the prudential supervision of credit institutions and the stability of the financial system in Article 127(5) of the Treaty, and (3) the tasks conferred upon the ECB concerning the prudential supervision of credit institutions pursuant to Article 127(6) of the Treaty. In accordance with the first sentence of Article 17.5 of the Rules of Procedure of the European Central Bank, the Governing Council has adopted this opinion.

**General observations**

The ECB welcomes the objectives of the proposed directive and regulation of promoting further integration of Union financial markets and deepening the Capital Markets Union (CMU). The ECB is in favour of a developed, harmonised, high-quality and transparent covered bond market in the Union and sees the proposed directive as an important step towards creating such a market. The ECB also sees merit in the proposed directive serving as a basis for new national legislation on covered bonds. However, the implementation of the proposed directive might not lead to full harmonisation to the extent that Member States will have flexibility in its implementation. The provided degree of flexibility should not endanger the objective of further convergence towards a common, high standard in all Member States.

The distinction made between different product regulations within the initiatives launched under the broader policy objectives of the CMU allows for product-specific considerations. In this context, the ECB supports the approach of the proposed directive whereby European secured notes would be dealt with in a separate legislative proposal. This approach respects the distinctive, high quality of assets contained in European covered bonds' cover pools and does not unnecessarily mix different asset classes.

<sup>(1)</sup> COM(2018) 94 final.

<sup>(2)</sup> COM(2018) 93 final.

The proposed directive makes provision for the supervision of covered bonds by national competent authorities. This product supervision is distinct from and without prejudice to the ECB's prudential supervisory tasks set out in Council Regulation (EU) No 1024/2013<sup>(1)</sup>. In particular, the proposed directive does not affect the ECB's exclusive task of authorising credit institutions and withdrawing authorisations of credit institutions<sup>(2)</sup>, which may, depending on the national legal framework, include a general authorisation to issue covered bonds. Similarly, the ECB remains competent to ensure that the prudential risks arising from covered bond issuances as well as investments in covered bonds are adequately managed and assessed by credit institutions.

The Eurosystem accepts covered bonds which fulfil the eligibility criteria for collateral in Eurosystem monetary policy operations. The Eurosystem purchases covered bonds in the Eurosystem's covered bond purchase programme (CBPP3) as part of its expanded asset purchase programme (APP)<sup>(3)</sup>. The proposed directive and regulation are independent of the Eurosystem collateral framework and the CBPP3 as these are monetary policy instruments that fall within the Eurosystem's exclusive competence.

### Specific observations on the proposed directive

#### 1. Definitions

It is suggested to add the term 'voluntary overcollateralisation' as an additional component of overcollateralisation, thereby making voluntary collateralisation subject to segregation requirements. Adding this would ensure that voluntary overcollateralisation is subject to the safeguards under Directive 2014/59/EU of the European Parliament and of the Council<sup>(4)</sup>.

#### 2. Eligible assets

2.1 The ECB welcomes the qualitative requirements for eligible assets by which covered bonds must be collateralised, which include both certain predefined high-quality assets<sup>(5)</sup> and 'other high quality assets' that meet certain requirements. However, regarding these 'other high quality assets', the relevant requirements may not be sufficient to ensure the harmonised treatment of assets as high-quality assets, taking into account the principle-based approach used in the proposed directive. Therefore, the ECB supports the introduction of stricter requirements into the proposed directive.

2.2 Regarding the eligibility of assets located outside the Union, a maximum share of such assets should be introduced to ensure the homogeneity of the cover pool, to foster the European character of the covered bond product and to support investors' understanding of cover pool risks.

2.3 The homogeneity of cover pool assets is a key feature of transparent, high-quality covered bonds and therefore homogenous pools consisting exclusively of one asset class are preferable. However, Member States may allow for mixed pools where they specify the safeguards needed to ensure that the risk profile of the assets in a pool is of a sufficiently similar nature and that the composition of the cover pool does not materially change over time.

2.4 The proposed directive should clarify that the segregation requirement applies to all assets, including assets held by way of overcollateralisation, including if such overcollateralisation is provided on a voluntary basis. This requirement should not, however, extend to other additional guarantees relating to covered bond programmes that are

<sup>(1)</sup> Council Regulation (EU) No 1024/2013 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions (OJ L 287, 29.10.2013, p. 63).

<sup>(2)</sup> See Article 4(1)(a) of Regulation (EU) No 1024/2013.

<sup>(3)</sup> Decision ECB/2014/40 of the European Central Bank of 15 October 2014 on the implementation of the third covered bond purchase programme (OJ L 335, 22.11.2014, p. 22).

<sup>(4)</sup> Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012, of the European Parliament and of the Council (OJ L 173, 12.6.2014, p. 190). See in particular Articles 76(2)(e) and 79(1)(a), which require Member States to ensure that there is appropriate protection for covered bonds arrangements so as to prevent, inter alia, transfer of some, but not all, of the assets, rights and liabilities which constitute or form part of a covered bonds arrangement to which the institution under resolution is a party. See also page 141 of the EBA Report on Covered Bonds: Recommendations on harmonisation of covered bond frameworks in the EU of 20 December 2016 (EBA-Op-2016-23), (the 'EBA Recommendation').

<sup>(5)</sup> Please see Article 129(1)(a) to (g) of Regulation (EU) No 575/2013.

required by national covered bond laws, but which do not form part of the overcollateralisation as such<sup>(1)</sup>. The proposed directive should also clarify that assets in the cover pool should be segregated either by: (a) registration of the cover pool assets in a cover pool register; (b) transfer of the cover pool assets to a special purpose vehicle; or (c) holding the cover pool assets in a specialised mortgage credit institution.

- 2.5 The supervision of covered bond issuers should be supplemented with cover pool monitoring on a continuous basis. The proposed directive should make the appointment of a cover pool monitor at issuance of a covered bond mandatory rather than merely voluntary. Such a requirement for a cover pool monitor is already well-established in the national legislation of many Member States. The cover pool monitor should at least comply with the minimum requirements set out in the proposed directive. The requirement that the cover pool monitor must be an entity separate and independent from the credit institution issuing covered bonds, and must also be an entity separate and independent from that credit institution's auditor, resolves any potential conflicts of interest.
- 2.6 Several provisions on investor information in the proposed directive are welcome. First, investor information is to be provided for all regulated covered bonds. Second, the frequency of disclosure of investor information has been increased from semi-annually to quarterly. Third, the scope of investor information to be provided has been extended to also cover contractual and voluntary levels of overcollateralisation as well as details on interest rate, currency, credit, market and liquidity risks. However, these provisions leave excessive room for interpretation of these requirements for issuers as well as competent authorities. The potential for a different approach for example to definitions and data formats could endanger a common understanding of the provided information. Therefore, in order to further facilitate investor due diligence and comparability of covered bonds, additional and more detailed information should be required. Moreover, the information should be presented in a template format.

### 3. Coverage and liquidity requirements

- 3.1 Whereas a common measurement of the coverage requirement based on a nominal calculation principle facilitates comparison of covered bonds across Member States and issuers, it cannot be applied to derivative contracts. Statutory overcollateralisation should be removed from the coverage requirement as its purpose is to ensure the provision of additional assets and thus it is already covered in other provisions of the draft directive. Not only uncollateralised, but also collateralised, claims where the obligor is unlikely to pay or the debt is overdue<sup>(2)</sup> should be left out of the calculation of coverage, because in these circumstances dual recourse would be weaker. A number of additional criteria are necessary to ensure investor protection. First, at least the same loan-to-value (LTV) limits as set out pursuant to Regulation (EU) No 575/2013<sup>(3)</sup> should apply for the calculation of the minimum coverage. In this respect, harmonisation of the LTV calculation should be ensured through the use of transparent indexation, at least an annual revaluation of the cover assets and use of the current loan balance instead of the original loan balance. Second, substitute assets should not be taken into account in the coverage requirement, or, at the very least, it would be prudent to impose a limit on the substitute assets to be considered in the calculation of the coverage requirement.
- 3.2 Assets qualifying as level 1 or level 2A<sup>(4)</sup> are considered liquid assets and therefore suitable for the cover pool liquidity buffer. Level 2B assets, which include, for example, asset-backed securities, corporate securities and shares meeting specified requirements<sup>(5)</sup>, are less liquid and should therefore not contribute to the cover pool liquidity buffer. Additionally, assets issued by the credit institution itself, its parent undertaking, its subsidiary, another subsidiary of its parent undertaking, or a securitisation special purpose entity with which the credit institution has close links<sup>(6)</sup>, should not be used as part of the liquidity buffer to prevent a concentration of companies within the issuer's group or affiliated with the issuer. Further, Member States should ensure a sufficient level of diversification<sup>(7)</sup> to enable a rapid liquidation of these assets without a significant loss in value.

<sup>(1)</sup> For example, in the case of Spanish covered bonds (cédulas) the entire mortgage portfolio constitutes an additional guarantee to the required level of overcollateralisation. The additional guarantee changes over time.

<sup>(2)</sup> See Article 178 of Regulation (EU) No 575/2013.

<sup>(3)</sup> See Article 129(1) of Regulation (EU) No 575/2013.

<sup>(4)</sup> See Articles 10 and 11 of Commission Delegated Regulation (EU) 2015/61 of 10 October 2014 to supplement Regulation (EU) No 575/2013 of the European Parliament and the Council with regard to liquidity coverage requirement for Credit Institutions (OJ L 11, 17.1.2015, p. 1).

<sup>(5)</sup> See Article 12 of Delegated Regulation (EU) 2015/61.

<sup>(6)</sup> See Article 7(3) of Delegated Regulation (EU) 2015/61.

<sup>(7)</sup> See Article 8(1) of Delegated Regulation (EU) 2015/61.

3.3 The cover pool liquidity buffer should cover the entire net liquidity outflow for 180 calendar days as liquidity buffers should also cover potential issuer insolvency scenarios. Therefore, there should be no disapplication of this requirement, as is currently the case under Article 16(4) of the proposed directive, which does not require a cover pool liquidity buffer if other liquidity requirements are provided for in other acts of Union law. However, the ECB appreciates that the existing requirement according to which, in order to be eligible to form part of a credit institution's liquidity buffer, assets must be free from any encumbrance <sup>(1)</sup>, would need to be clarified in this context.

3.4 The proposed directive would allow for the calculation of the principal redemption for covered bonds with extendable maturity structures to be based on the extended final maturity date instead of the scheduled maturity date in the context of the requirement for a cover pool liquidity buffer. This *de facto* means that for these types of covered bonds there is no liquidity buffer requirement for the principal redemption on the scheduled maturity date. The requirement for a cover pool liquidity buffer for the calculation of the principal redemption for covered bonds with extendable maturity structures should be based on the scheduled maturity date as there is an expectation that these covered bonds will be repaid on the scheduled maturity date and non-payment on the scheduled maturity date may have significant funding risks for the credit institution. The maturity of such covered bonds should not, in the normal course, be extended if there are sufficient monies to pay the covered bondholders at the scheduled maturity. Hence, not having a liquidity buffer for the principal redemption on the scheduled maturity date may increase the likelihood of the maturity of such covered bonds being extended <sup>(2)</sup>.

#### 4. *Soft bullet and conditional pass-through structures*

4.1 There has been a rapid development of innovative covered bond structures, which requires careful ongoing assessment to ensure sustainable market development. In particular, over the past few years covered bonds with extendable maturity structures whereby the scheduled maturity date of the covered bonds can be extended by the issuing credit institution have been used more extensively, while the specific risks posed by these structures may not have been sufficiently considered <sup>(3)</sup>.

4.2 The proposed directive allows for extendable maturity structures under certain conditions. In the ECB's experience, it is not possible to fully exclude the discretionary triggering of a maturity extension in all Member States due to differences in national legal frameworks applicable to covered bonds, the potential for variations in the contractual provisions of a covered bond programme as well as differences in how national law treats defaults and non-payment in the absence of prohibitions on voluntary trigger of a default. By allowing the extension triggers to be contractually defined, the proposed directive could result in significant heterogeneity across covered bonds, which hinders harmonisation. Therefore, it is suggested that only statutory triggers prescribed by law should be allowed, and contractual triggers should be excluded.

4.3 In this respect, it is noted that the European Banking Authority (EBA) has proposed a set of specific conditions that should be complied with by covered bonds with extendable maturity structures in order to be eligible for preferential risk weight treatment. In particular, the maturity extension may only be effected upon the following triggers taking place (both triggers must occur cumulatively): (i) the covered bond issuer must have defaulted and (ii) the covered bond breaches certain pre-defined criteria/tests indicating a likely failure of the covered bond to be repaid at the scheduled maturity date <sup>(4)</sup>. These two requirements would limit any potential discretion of the issuing credit institution over the maturity extension.

#### 5. *Effective cooperation between supervisory authorities*

Given the ECB's competence regarding credit institutions' prudential risks, it is important for the ECB to ensure that risks arising from covered bond issuances are adequately managed. Therefore the ECB should be able to request relevant information on an ad-hoc basis from the competent authorities responsible for covered bond public supervision in order to take this information into account for the ongoing prudential supervision of the respective credit institution.

<sup>(1)</sup> See Article 7(2) of Delegated Regulation (EU) 2015/61.

<sup>(2)</sup> See also paragraph 2.2.4 of Opinion CON/2017/46. All ECB opinions are published on the ECB's website at [www.ecb.europa.eu](http://www.ecb.europa.eu)

<sup>(3)</sup> See also pages 17 and 18 of the 'ECB contribution to the European Commission's consultation on Capital Markets Union mid-term review 2017,' available on the ECB's website.

<sup>(4)</sup> See page 137 of the EBA Recommendation.

## 6. *Label*

Whilst the concept of a specific label for covered bonds issued by credit institutions established in the Union has its merits, some questions, such as the competent authority to grant the label and specified requirements relating to the granting of the label, remain to be clarified at Member State level. The possibility cannot be entirely excluded that some investors might confuse the abbreviated name of the label, European Covered Bond (ECB), with the abbreviation of the European Central Bank (ECB). Therefore, a more neutral name, e.g. EU Covered Bond, might be preferable.

### **Specific observations on the proposed regulation**

#### 7. *Overcollateralisation and substitution assets*

- 7.1 The ECB welcomes a harmonised approach towards minimum overcollateralisation. A uniform calculation method without exceptions is favoured. The ECB therefore has reservations about the proposal to apply different requirements in certain situations. Notwithstanding the challenges of a common requirement across the Union, the ECB takes note of the recent Basel Committee standards <sup>(1)</sup> and considers a 5 % requirement as a sensible position.
- 7.2 The ECB welcomes the fact that the proposed regulation clarifies that LTV limits should be applied as soft coverage limits. For example, there are no limits on the size of an underlying loan, but such a loan can only contribute to the requirements for coverage up to and including the applicable LTV limit. This LTV limit should be applied not only upon inclusion of such loan but throughout the entire maturity of the loan. In this respect, it is important that the entire loan amount, including the loan part in excess of the applicable LTV limit, is subject to the segregation of assets in the cover pool in accordance with the proposed directive. For the purpose of the LTV limits, it would be prudent for the property value to be monitored and updated at least on a yearly basis by using an indexation method, in addition to the other requirements for immovable property collateral that are set out in Article 208 of Regulation (EU) No 575/2013.
- 7.3 Given the difficulties in shipping finance, due to the highly cyclical nature of the shipping industry <sup>(2)</sup>, it would be appropriate to exclude covered bonds which are collateralised by loans secured by maritime liens on ships, from preferential treatment in accordance with Article 129(4) and (5) of Regulation (EU) No 575/2013.
- 7.4 It is prudent that the assets that may contribute to mandatory overcollateralisation should be eligible assets as listed in the proposed regulation, and be subject to the same limits on exposure size as set out in the proposed regulation.
- 7.5 It is important to have qualitative requirements for substitution assets for covered bonds, and it is appropriate that the same requirements apply as for eligible assets in accordance with the proposed regulation. However, these qualitative criteria should be supplemented with a quantitative limitation <sup>(3)</sup>. This quantitative limitation would further regulate the composition of the cover pool to ensure its homogeneity and would facilitate investors' ability to conduct due diligence. According to the EBA's analysis, a significant majority of national covered bond frameworks regulate substitution assets in terms of composition and quantitative limits <sup>(3)</sup>. The ECB would therefore recommend including in the proposed regulation a requirement that substitution assets must not exceed 20 % of the total nominal amount of all outstanding covered bonds of the issuer.

Where the ECB recommends that the proposed directive and regulation are amended, specific drafting proposals are set out in a separate technical working document accompanied by an explanatory text to this effect. The technical working document is available in English on the ECB's website.

Done at Frankfurt am Main, 22 August 2018.

*The President of the ECB*

Mario DRAGHI

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<sup>(1)</sup> See Basel III: Finalising post-crisis reforms, 7 December 2017, available on the Bank for International Settlement's website at [www.bis.org](http://www.bis.org) considering a 10 % requirement.

<sup>(2)</sup> See 'ECB Banking Supervision reviews lending to troubled shipping sector', 17 May 2017, available on the ECB's Banking Supervision website at [www.bankingsupervision.europa.eu](http://www.bankingsupervision.europa.eu)

<sup>(3)</sup> See page 139 of the EBA recommendation.