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**REPORT FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT AND
THE COUNCIL**

**on Article 503 of Regulation (EU) No 575/2013
Capital requirement for covered bonds**

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CAPITAL REQUIREMENTS FOR COVERED BONDS

BACKGROUND

Covered bonds are debt obligations issued by credit institutions and secured on the back of a ring-fenced pool of assets (the "**cover pool**" or "**cover assets**") which bondholders have direct recourse to as preferred creditors. Bondholders remain at the same time 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 assets. This double claim against the cover pool and the issuer is denominated the "dual recourse" mechanism. Furthermore, the cover pool comprises high quality assets, typically, but not exclusively, mortgage loans and public sector debt. 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 to replace assets that become non-performing or, otherwise, do not meet relevant eligibility criteria.

The features described above contribute to make covered bond low-risk debt instruments, thus providing a rationale for the beneficial regulatory capital requirements set out in Article 129 of Regulation 575/2013 (the "**CRR**"). 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 otherwise apply to senior unsecured bank debt (eg 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). These comparative lower capital requirements are referred to by the CRR as "preferential risk weights".

These preferential risk weights are, however, only available for "qualifying covered bonds", that is, those backed by the high quality assets laid down in that Article 129 of the CRR. Cover pools may, *inter alia*, include qualifying senior units issued by French *Fonds Communs de Creances* ("**FCCs**") or equivalent securitisation instruments up to a maximum of 10% of the covered bonds' outstanding issue amount, and that limit may be derogated by competent authorities in accordance with Article 496 of the CRR until 31 December 2017.

Article 503 of the CRR mandates the Commission to report to the Co-legislators on a number of items related to the regulatory capital treatment of covered bonds under the CRR, having regard to the recommendations made by the European Banking Authority ("**EBA**") on each of the matters set out in Section 10 of EBA's "Report on EU Covered Bond Frameworks and Capital Treatment" (the "**EBA Report**").

ITEM NO. 1: ARE PREFERENTIAL RISK WEIGHTS APPROPRIATE FOR COVERED BONDS?

Paragraph 1 of Article 503 of the CRR mandates the Commission to report on whether the preferential risk weights laid down in Article 129 and the own funds requirements for specific risk in Article 336(3) of the CRR are adequate for qualifying covered bonds having regard to the various types of cover assets, level of transparency on the cover pool and the impact of covered bond issuance on the issuer's unsecured creditors (asset encumbrance).

On the general question concerning the appropriateness of the preferential risk weights, the EBA opined 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**"¹.

Having regard to the above, the Commission submits the following in accordance with paragraph 1 of Article 503 of the CRR:

- while the decision of Member States' governments to support or even bail-out certain covered bond issuers could have contributed to the complete absence of formal defaults, the Commission acknowledges that the overall credit performance of European covered bonds was very robust throughout recent periods of market stress between 2008 and 2012, in particular compared with other financial instruments (namely asset-backed securities). The three Eurosystem Covered Bond Purchase Programmes also played an important role in ensuring liquidity in European covered bond markets;
- the EBA Report shows that the double recourse principle is effectively embedded in the covered bond laws of Member States consistent with the requirements set out in Article 52(4) of Directive 2009/65/EC and those laws largely follow the credit quality, underwriting and transparency standards set out in Article 129 of the CRR. Although the degree of harmonisation of covered bond laws brought about by these provisions has only been indirect and high level, the Commission recognises that it has nevertheless contributed to enhancing financial stability for the overall market and creating a benchmark of quality that investors seek to rely on.

Accordingly, the Commission agrees with the EBA's recommendation that the preferential risk weights currently laid down in Article 129 and the own fund requirements for specific risk in Article 336(3) of the CRR **remain an adequate prudential treatment for qualifying covered bonds**.

Without prejudice to the above, the EBA Report shows that Member States' covered bond laws differ quite significantly in some key technical aspects, in particular those relating to the safety and transparency of these instruments. In order to justify the on-going existence of the preferential prudential treatment, the EBA recommends more convergence between Member States' covered bond laws on the basis of the best practice principles set out in the Report. Such convergence could not be achieved only through changes to the qualifying criteria set out in Article 129 of the CRR as the scope of such article is limited to the prudential treatment of a subset of these instruments. The Commission, therefore, intends to seek stakeholder feedback on the convenience and shape of an integrated EU covered bond framework through a dedicated Consultation Paper on covered bonds ("CP"), as it was announced in the CMU Green Paper on 18 February.

In relation to the specific matters set out in paragraph 2 of Article 503 of the CRR, the Commission submits the following:

- preferential risk weights should continue to be applied uniformly to all qualifying covered bonds, without distinction between asset classes or Member State of origination. The

¹ Recommendation EU COM 1 (see page 148 of EBA Report)

Commission, however, would like to discuss with stakeholders whether it would be appropriate: (i) to replace the high level conditions set out in Article 129 of the CRR with a set of more comprehensive qualifying criteria and (ii) to recognise secured instruments using covered bond-like structures backed by loans that fund non-financial activities for the purposes of a hypothetical European legal/regulatory framework (see Item No. 2 of this Report);

- the disclosure requirements towards investors forming part of the eligibility criteria in Article 129 of the CRR should not be changed at this juncture. However, the Commission intends to seek feedback from stakeholders on the convenience and manner of applying detailed and consistent disclosure requirements on issuers in relation to the credit, market and liquidity risks of European covered bonds and their underlying cover assets;
- at this juncture, there should be no changes to Article 129 of the CRR taking into account the risk to which other creditors of the issuer institution are exposed. Although asset encumbrance in favour of covered bondholders has an impact on the risk borne by other creditors of the issuer, this issue has been addressed through the minimum requirement for own funds and eligible liabilities (MREL) laid down in Directive 2014/59 (the "BRRD"), and continues to be monitored by supervisors and macroprudential authorities.

ITEM NO. 2: ARE PREFERENTIAL RWs APPROPRIATE FOR AIRCRAFT LOANS

Paragraph 3 first part of Article 503 of the CRR mandates the Commission to report on whether covered bonds secured by aircraft loans (aircraft liens) should, under certain conditions, be considered as eligible asset in accordance with Article 129 of the CRR. This type of covered bonds is not included among those currently eligible in accordance with this Article.

In relation to this, the EBA concluded that "based on the qualitative and quantitative evidence included within this report the EBA considers that **it would not be appropriate to include loans secured by aircraft liens** among the underlying asset classes eligible for the risk weight preferential treatment provided for in Article 129 of the CRR"².

Having regard to the EBA's analysis and recommendation on this matter, **the Commission does not intend to make any proposals at this juncture to amend Article 129 of the CRR** in order to include aircraft loans as eligible assets. The Commission, however, intends to seek feedback from stakeholders on the appropriate treatment for securities backed by loans that fund non-financial activities (which would include not only aircraft but also ship and SME loans). The Commission is very keen on striking the right balance between an adequate prudential treatment for covered bonds and other forms of secured lending and the potential benefit in terms of economic growth that may result from encouraging sound lending to the real economy on the back of covered bond-like technology using these assets as collateral.

ITEM NO. 3: ARE PREFERENTIAL RWs APPROPRIATE FOR GUARANTEED RESIDENTIAL LOANS

Paragraph 3, second part of Article 503 of the CRR mandates the Commission to report on whether covered bonds guaranteed by residential loans should, under certain conditions, be considered as eligible assets in accordance with Article 129 of the CRR. Guaranteed

² Recommendation EU COM 2-A (see page 111 of EBA Report)

residential loans are currently subject to the eligibility requirements set out in paragraph 1(e) of this Article.

In relation to this, the EBA concluded that "Based on the qualitative and quantitative evidence included within this report the EBA considers it appropriate to maintain residential loans secured by a guarantee within the scope of preferential risk weight treatment. However the EBA deems appropriate that, in addition to the qualifying criteria currently included in Article 129(1)(e) of the CRR, the following additional criteria be considered for inclusion:

- the national legal/regulatory covered bond framework should not allow borrowers to place mortgage liens on the loans included in the cover pool;
- the national legal/regulatory covered bond framework should be such that no legal impediments exist for the administrator of the covered bond programme to place mortgage liens on the loans included in the cover pool, in a scenario where the covered bond issuer has entered default or resolution and where the guarantee, for any reasons, ceases to exist".³

The Commission is of the view that it is appropriate to continue treating qualifying guaranteed residential loans as eligible assets. In relation to the additional criteria recommended by the EBA, the first one is already included in the eligibility requirements in Article 129 of the CRR. The Commission intends to seek stakeholder feedback on the second additional criterion.

ITEM NO. 4: REVIEW OF THE ARTICLE 496 DEROGATION

Sub-item no. 4.1: Derogation for covered bonds backed by securitisation instruments

Paragraph 4 of Article 503 of the CRR mandates the Commission to review whether the derogation set out in Article 496 of the CRR is appropriate and should be applied to other types of covered bonds. Specifically, reference is made to the derogation from the 10% limit for senior units issued by French FCCs or equivalent securitisation instruments laid down in points (d) and (f) of Article 129(1) of the CRR which competent authorities may grant to credit institutions until 31 December 2017. For the avoidance of doubt, references to "securitisation instruments" in this Report must be understood as including senior units issued by FCCs.

The EBA expresses overarching prudential concerns on the use of securitisation instruments as cover assets in excess of the above-referred 10% threshold 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. In light of these concerns, the EBA **"considers it appropriate that the derogation to the 10% limit for**

³ Recommendation EU COM 2-B (see page 123 EBA Report)

senior securitisation units currently foreseen in Article 496 of the CRR, be removed after 31 December 2017"⁴.

Although a double-layer feature involving securitisation instruments may make these structures relatively less transparent and more complex to manage from a risk mitigation perspective than one layer structures, it may be possible to address some of the concerns expressed by EBA through the use of simple and transparent structures. The Commission would like to discuss with stakeholders the broader issue of the eligibility of securitisation instruments as cover assets, the criteria and limits that should apply to them and the interaction with the Commission's initiative on Simple, Transparent and Standard securitisations in the context of the Capital Markets Union project.

Sub-item no. 4.2: Derogation for covered bonds backed by other covered bonds

The EBA notes that in at least one Member State, the derogation in Article 496 of the CRR has been granted to intra-group covered bond structures: in these, covered bonds issued by members of the same group are pooled together in a separate legal entity which issues covered bonds to final investors. In relation to these structures, EBA "recommends that the Commission should further consider whether a specific provision could be introduced in Article 129 of the CRR making it possible to allow specific intra-group transfers of CRR-compliant covered bonds as eligible collateral. From a prudential perspective, no additional risk appears to be introduced by such provision, provided that the entity is sufficiently integrated within the group"⁵.

The Commission acknowledges that structures involving covered bonds backing other covered bonds do not raise the same complexity issues described for transactions backed by securitisation instruments, insofar as there may be a better alignment between the features of the covered bonds in both layers of the transaction. In addition, there may be specific merits to allowing the pooling of covered bonds from different issuers as cover assets generally, not only for intra-group funding purposes. For instance, these types of structures have been commonly used by smaller covered bond issuers in various Member States as a means to gain issuance volume through the larger combined size of their cover pools and, thus, be able to access capital markets in better economic terms than might be otherwise available to each individual issuer.

Accordingly, the Commission intends to consult further with stakeholders on the appropriate legal and regulatory treatment of covered bond structures pooling cover assets originated or issued by other issuers. Structures involving covered bonds issued for intra-group funding purposes as currently used should be considered as part of this debate.

CONCLUSIONS

Items no. 1 to 3

The Commission does not propose amending Article 129 of the CRR at this stage in relation to the matters referred to by items no. 1 to 3. There would be little merit in engaging in such an amendment before stakeholders have had the opportunity to comment on the relative merits of each of the relevant policy options presented in the CP.

⁴ Recommendation EU COM2 –C (page 128 of EBA Report)

⁵ See footnote in page 128 of EBA Report

Following the review of feedback received, the Commission may submit legislative proposals which may consist in targeted amendments to Article 129 of the CRR or its repeal if replaced by a covered bond framework.

Item no. 4

The Commission will wait to review stakeholder feedback to the CP to decide whether it would be appropriate to let Article 496 derogation lapse, make it permanent or replace it with a covered bond framework that may include provisions on covered bond structures backed by securitisation instruments.

The same applies to the matter of applying Article 496 derogation to other forms of covered bonds, specifically the pooled covered bond structures referred to in sub-item No. 4.2.