BRIEFING

Initial Appraisal of a European Commission Impact Assessment

European Parliament

A framework for EU covered bonds

Impact assessment (SWD(2018) 50, SWD(2018) 51 (summary)) accompanying a Commission 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 (COM(2018) 94) and a Commission proposal for a regulation of the European Parliament and of the Council amending Regulation (EU) 575/2013 as regards exposures in the form of covered bonds (COM(2018) 93)

This briefing provides an initial analysis of the strengths and weaknesses of the European Commission's impact assessment (IA) accompanying the above-mentioned proposals for a directive and a regulation, submitted on 12 March 2018 and referred to Parliament's Committee on Economic and Monetary Affairs.

Covered bonds are debt obligations issued by credit institutions (mainly banks) and secured by earmarked assets (mainly mortgage or public sector debt) on which investors have a priority claim. There is no formal, universally accepted definition of covered bonds, but the following characteristics are considered to define them: 1) dual recourse mechanism; 2) asset segregation and dynamic cover pool; and 3) strict legal and supervisory frameworks.[1] They are regulated mainly at national level. At EU level, there is no single, harmonised legal framework for covered bonds, and the legislation relating to them is interwoven in the provisions of different regulations and directives.[2] Due to their features, covered bonds are considered a low-risk debt instrument, therefore banks investing in them do not have to set aside as much regulatory capital as when they invest in other assets, and covered bonds benefit from preferential prudential and regulatory treatment.

Against this background, the European Commission is proposing an EU legislative framework for covered bonds. The proposal builds on the European Banking Authority's (EBA) 2014 and 2016 reports,[3] the latter advocating legislative action to harmonise covered bonds at EU level. The European Parliament's resolution of June 2017[4] on covered bonds supported their harmonisation at EU level, calling on the Commission to present a proposal for a principles-based directive for a European covered bonds framework. The enabling framework for covered bonds was included in the 2018 Commission work programme (CWP) under the new initiatives aimed at completing the Capital Markets Union (CMU).

Problem definition

The IA identifies two 'sets of concerns' (IA, p. 14):

1. Untapped CMU potential: covered bond markets are currently fragmented along national borders, and national regulatory frameworks differ significantly;
2. Prudential concerns associated with the preferred treatment enjoyed by the covered bonds, given that EU law does not comprehensively define covered bonds and much is left to national legislation.

The first set of concerns relate to the following issues (IA, pp. 14-20):

1. Unevenly developed markets

Covered bond issuance is dominated by a few Member States.[5] Nine Member States do not have any covered bond markets.[6] The reasons why covered bonds developed in some Member States and not in others are partly historical. There are, however, important regulatory factors that play a crucial role in the development of covered bond markets, according to the IA. These include: 1) the existence of an enabling regulatory framework that commands confidence among investors; and 2) broader regulatory elements related to the insolvency framework and the enforceability of collateral, including foreclosure

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processes and legal aspects of asset transfer. Furthermore, the expectation of EU action on a covered bond framework has played a role in postponing the adjustments in some jurisdictions.

2. Undiversified investor base

The main investors in covered bonds are banks and central banks, while the uptake from other financial institutions (insurance companies, pension funds and assent managers) is limited. The lack of diversification leads to prudential concerns, in terms of increased concentration of risks. If covered bonds end up being mostly acquired by other banks, this does not bring additional liquidity to the sector and concentrates credit risks within the sector itself, creating interconnectedness.

3. Untapped potential for investments across the single market

Although cross-border investment in covered bond markets across the EU currently represents 60 % of total covered bond investments, this figure overstates the current activity in the EU. The bulk of such investments come from countries with a strong covered bond tradition, Germany being particularly dominant, and takes place across the countries with similar covered bond and mortgage legislation (for example, Nordic countries investing in other Nordic countries). Furthermore, cross-border cover pools (assets from jurisdictions other than the one in which the issuer is based) remain limited.

4. Limited third-country investments

Currently, investments from outside the EU represent a small share of the market as only 11 % of EU issued covered bonds are held outside the EU, compared to 16.5 % of total debt securities, according to Commission estimates (IA, p. 20). It is unlikely that third-country investors will dedicate time and resources to perform due diligence of the different characteristics of more than 25 non-harmonised national regimes.

The second set of concerns relate to the following (IA, pp. 20-23):

1. Diversity in national covered bond frameworks and risk of misalignment with preferential prudential treatment

The only piece of EU legislation that defines a covered bond is Article 52 of the Undertakings for Collective Investment in Transferable Securities (UCITS) Directive. However, this provision has never been intended to serve as the general definition of covered bonds as a financial instrument. Currently, the only structural features it defines are the nature of the issuer, the dual recourse principle and the special public supervision. Over time, covered bond instruments have further developed and national legislations now contain elements that go beyond the narrow definition provided by the UCITS Directive. These divergences extend beyond regulatory frameworks and are also observed in actual supervisory practices of individual competent authorities in the execution of special public supervision. The diversity of national frameworks means that covered bonds with diverse characteristics benefit from the same preferential treatment. This may give rise to prudential concerns.

2. Preferential capital treatment not adequate

The Commission services believe that the treatment provided in Article 129 of the Capital Requirements Regulation (CRR) is not adequate and should be strengthened in line with the 2016 EBA report, in relation to: 1) disclosure requirements for the issuers; 2) rules on substitution assets; 3) loan-to-value limits for cover assets collateralised on physical property (i.e. for mortgage cover pools); and 4) minimum over-collateralisation.

3. Not addressing new risks resulting from financial innovation

The combination of EU and national frameworks is inadequate to deal with financial innovation and the resulting use of new features, which may pose risks that are not in line with the current preferential treatment. Although covered bonds containing new features, known as 'soft-bullet' and 'conditional pass-through' (CPT), represent a relatively limited share of the overall market for outstanding covered bonds, their market share is increasing.

The IA includes a 'problem tree' diagram, depicting the drivers, problems and their consequences (the latter are the same as the above-mentioned 'sets of concerns', IA, p. 24). On the same page, the IA indicates that the 'European Central Bank (ECB) covered bonds programme, investor and issuer preferences, market conditions, macroeconomic developments, etc.' are 'out-of-scope drivers', but does not provide any explanation. The discussion of problems and their consequences draws on literature sources, International Monetary Fund (IMF) and ECB data, public consultation results, the IA supporting study[7] and EBA reports. Overall, the problem definition provided in the IA is coherent and clear, except for somewhat confusing terminology ('sets of concerns' seem to be referring to 'problems', while 'problems' resemble 'problem drivers'). Furthermore, the IA could have explained why some of the problem drivers were left outside the scope of the report.

Objectives of the initiative

The two general objectives of the Commission proposal are defined as follows (IA, pp. 25-26):

1. Enhance CMU potential, leveraging banking capacity to support the wider economy;
2. Address prudential concerns and ensure the coherence of preferential prudential treatment.

To achieve the general objective 1, the following specific objectives have been developed (IA, pp. 25-26):

1. Contribute to the development of covered bonds markets in EU countries where they do not exist or are less developed, both from the geographical perspective, and in terms of issuer size;
2. Diversify covered bonds investor base;
3. Tap the potential for more cross-border investments;
4. Attract investors from third countries.

To achieve the general objective 2, the following specific objectives have been developed (IA, p. 26):

1. Define the structural features of covered bonds in EU law in order to align the structural characteristics of covered bonds across the EU with the risk features underlying the EU preferential treatment;
2. Strengthen the requirements for benefiting from preferential prudential treatment under the CRR;
3. Define a framework for newly developed liquidity structures (soft-bullets and CPT programmes).

The specific objectives align with the problems and the general objectives align with the problem consequences identified above. The IA provides benchmark benefits and monitoring indicators for the specific objectives, as well as (overall) benchmark costs and their monitoring indicators (IA, pp. 74-75). The data sources for the indicators are also specified. However, the IA does not set operational objectives under the preferred option, neither does it set time-bound (SMART) objectives, as the Better Regulation (BR) Toolbox (Tool #16) requires.

Range of options considered

The policy options have been devised along the following policy areas: 1) structural features of covered bonds (e.g. dual recourse); 2) assets allowed in the cover pool; 3) supervision of covered bonds; 4) whether or not EU covered bonds should be granted a label; 5) preferential treatment enjoyed by covered bond investors under EU law; 6) transparency requirements; and 7) other technical aspects. Each of the four options considered covers all the policy areas with a different degree of harmonisation at different levels. These options are summarised in the table below.

	Structural features	Cover pool	Supervision	Label	Preferential treatment	Transparency	Technical aspects
Baseline	Mainly national	National	National	Market	EU	Market	National
Option 1	Mainly national	National	National	Market	EU	Market	National
Option 2	EU	National and EU	National and basic EU rules	EU	EU revised / strengthened	EU	EU principles and national details

Option 3	EU only	EU	National/SSM[8] and detailed EU rules	EU	EU revised / strengthened	EU	EU principles and details
Option 4	EU (national for parallel regimes)	EU (national for parallel regimes)	National/SSM and detailed EU rules	EU	EU revised / strengthened	EU	EU principles and details (national for parallel regimes)

Source: IA, pp.27-28.

Baseline scenario – no action at EU level

Under this scenario, the policy areas related to covered bonds would remain regulated at the levels indicated in the table above. Based on the EBA survey, covered bonds issuance in the short term is expected to increase by around 50 % compared to 2017 on the largest and most established EU covered bond markets. In the absence of EU action, market bodies might try to regulate the market themselves (e.g. by developing further standardisation practices) and Member States might change their laws to conform to EBA best practices. At the same time, credit rating agencies could induce issuers to comply with international standards (e.g. EBA best practices) independently of national rules. However, any convergence would be voluntary, so there is no certainty that actors in the market would comply and that harmonisation would actually take place.

Option 1 – non-regulatory option

The main difference with the baseline would be the active role the Commission would play alongside the EBA in issuing recommendations and best practices, and strengthening the market standards. EU recommendations could provide backing both for the EBA best practices and for market-led self-regulation initiatives. This could encourage Member States to draft sensible covered bond frameworks and align them with EU recommended best practices. The disadvantages of this option are very similar to those of the baseline: there is no certainty that actors in the market would comply and that harmonisation would actually take place. Moreover, this option has been discarded by a large majority of institutional stakeholders and the majority of market stakeholders.

Option 2 – minimum harmonisation based on national regimes (directive)

Under this option, structural features of the covered bonds would be regulated at EU level through a dedicated directive replacing the principles contained in Article 52 of the UCITS Directive. This new directive would provide a definition of the structural features and serve as a point of reference for preferential treatment to investments in covered bonds. The cover pool would be regulated both at EU and national level, with principles set at EU level and implementing measures at national level. The directive would define principles that guarantee the high quality of assets in the cover pool, without listing what type of assets can be used or explicitly excluding any of them. Article 129 of the CRR would continue to list the assets that make covered bonds eligible for preferential capital treatment, with the possibility to reassess some assets, such as ships. Areas that the special public supervision should cover would be defined at EU level, while the Member States would decide how such supervision should actually take place. This option would introduce a 'European covered bond' label. Issuers would be able to (voluntarily) use this label when marketing their bonds, provided that the product complies with the requirements set out in the directive. Preferential treatment would only be granted to covered bonds compliant with the requirements set out in the directive. In some cases (for example, capital preferential treatment under the CRR's Article 129), additional conditions would need to be met to become eligible for preferential treatment. Overall eligibility conditions for preferential treatment would be strengthened. The directive would set the transparency requirements in the form of increased disclosure, frequency and granularity. Other technical aspects would be considered mostly in the form of principle-based provisions, leaving leeway to Member States to translate those principles into more detailed requirements.

Option 3 – full harmonisation replacing national regimes (regulation)

This option would involve the design of a new, fully harmonised regime for covered bonds at EU level that would define every detail of a covered bond framework and replace existing national regimes. Thus, it would include a comprehensive definition of the structural features of a covered bond that would replace the covered bond-related provisions in the UCITS Directive, and it would contain an explicit list of cover assets allowed in the covered pool. Supervision would remain with national competent authorities for the less significant institutions and for the banks outside the euro area, and would go to the Single Supervisory Mechanism (SSM)/ECB for the largest banks in the euro area. The EU covered bond label would replace all the existing national labels. Preferential treatment and transparency requirements would undergo the same changes as in option 2. Technical aspects would be included in the EU framework with a sufficient degree of detail and leaving no leeway to the Member States to implement them. Option 3 would require a significant amount of implementing legislation.

Option 4 – 29th regime operating in parallel to national regimes

Option 4 would be very similar to option 3 with the difference that instead of substituting the current 28 regimes with a new one, the newly created regime would co-exist and operate in parallel and compete with the existing regimes, becoming the 29th regime. If successful, the 29th regime could be expected to gradually replace the existing ones instead of directly superseding them from the outset. This replacement would happen on the basis of voluntary adoption by market actors. The content of the new regulatory framework would largely resemble the one under option 3. The competent authorities would have to supervise two separate regimes: the national one and the European one. Two sub-options would be available for preferential treatment. Sub-option 4.1 is a neutral approach, meaning that existing EU rules granting preferential treatment would stay in place and continue to grant preferential treatment, both to EU covered bonds issued under the 29th regime, and to covered bonds issued under national frameworks as is the case now. However, this may provide insufficient incentives for market participants to use the new 29th regime. Therefore, sub-option 4.2 provides incentives to pursue the maximum uptake of the 29th regime in that the current preferential treatment at EU level would be reserved exclusively for the 29th regime, with high costs of disruption of existing markets.

The IA **discarded** the policy option of adjusting the prudential treatment, instead of harmonising the structural requirements of the instrument (IA, p. 38). This option was discarded because of the lack of stakeholder support and the significant disruption it would cause to well-functioning markets with no apparent compensating benefits (IA, p. 39).

The overall presentation of the options' content is clear and balanced. Alignment with the 2016 EBA advice and the European Parliament's 2017 resolution is discussed for each regulatory option. The IA also provides a brief summary of the advantages and disadvantages of each option. **The preferred option is option 2.**

Scope of the impact assessment

The IA analyses the costs and benefits of each policy option in depth. The benefits are assessed against the general and specific objectives set in the IA. The costs and benefits are quantified for the first general objective and assessed qualitatively for the second general objective. The options are compared in terms of effectiveness, efficiency and coherence. The proportionality of options is not part of the assessment, which is contrary to the recommendations of the BR Guidelines. Option 2 is expected to achieve the objectives at less cost than options 3 and 4, and promises the best possible balance across the effectiveness, efficiency and coherence criteria, according to the IA (p. 72). The analysis of impacts on SMEs, environmental and social impacts is done in a qualitative way and covers only the preferred option. The IA states that fostering covered bond markets would contribute to lower interest rates on mortgages (social impacts) and could support the financing of energy efficient investments (environmental impacts). However, these statements are not substantiated with data. The IA acknowledges that the baseline varies strongly across the Member States and discusses the potential impacts of each option for some Member States. In particular, among the largest markets, Italy and Spain would suffer the most significant increases in costs under the preferred option (IA, p. 62). The preferred option is expected to generate benefits for the issuers who would enjoy a lowering of funding costs (between 50 % and 75 %

of the benchmark €2.2-2.7 billion per year) and for citizens, who would enjoy lower borrowing costs (between 50 % and 75 % of the benchmark €1.5-1.9 billion per year). Investors would benefit from a stronger, more protective regime; however, when implementing the directive Member States might introduce some details that would also weaken the regime. Costs under the preferred option would increase for issuers (one-off direct costs are expected to converge towards the €1.8 million benchmark, and recurring costs towards the range between €300 000 and €475 000 per jurisdiction) and supervisors (especially in Member States where supervision is currently following the 'light touch' approach) would tend towards the benchmark of €25 350 per issuer-year), while they would decrease for investors and society (IA, pp. 90-95).

Subsidiarity / proportionality

The Commission proposal is based on Article 114 TFEU (internal market provisions). According to the IA, a directive represents the best means to achieve the stated objectives while respecting the principle of subsidiarity (IA, p. 25). The IA does not check the regulatory options in the light of the principles of subsidiarity or proportionality. At the time of writing, no national parliament has submitted a reasoned opinion on this proposal. The deadline for doing so is 16 and 17 May 2018 for the proposed regulation and directive respectively.[9]

Budgetary or public finance implications

According to the IA's executive summary, there will be no significant impacts on national budgets and administrations. Costs for supervisors (competent authorities) would increase, especially in Member States where supervision is currently following the 'light touch' approach, as explained above. According to the proposals' explanatory memoranda, they will have no implications for the EU budget.

SME test / Competitiveness

The preferred option would have some direct and indirect positive effects on SME financing (IA, p. 73). However, the most significant benefit for SMEs would come from the European Secured Note (ESN) initiative, which has a separate IA process.[10]

Simplification and other regulatory implications

According to the proposals' explanatory memoranda, the package on covered bonds, in particular the proposed directive, aims at harmonising an area currently regulated mainly at national level. The minimum harmonisation in the directive would bring simplification in terms of basic alignment of core elements of national regimes.

Quality of data, research and analysis

A supporting study on the proposal was carried out by external consultant ICF and is available online. The study assessed the potential costs and benefits of moving ahead with a legislative framework for covered bonds. Furthermore, the IA takes into account the 2014 and 2016 EBA reports and the 2017 Parliament resolution. The extent to which the general objective 1 would be achieved under each option was measured against the set of benchmarks that define the maximum benefits. A similar approach was followed to assess the costs of each option. The benchmark costs were derived from the costs currently borne by stakeholders in those jurisdictions which are more in line with the potential EU framework. The assessment of costs and benefits of general objective 2 was done in a qualitative way (IA, pp. 41-49). The IA openly states the assumptions applied in the analysis and the difficulties in quantifying the benefits of achieving general objective 2. Annex 4 explains the analytical methods used to estimate the benefits of achieving general objective 1. The estimates are based on the ICF study and the Commission services' estimate. Annex 5 contains further data and explanations on costs based on the ICF online survey, open public consultation responses, and detailed data collected from supervisors.

Stakeholder consultation

The IA identifies the stakeholders affected by the problem and the proposed initiative as covered bond issuers, investors, national competent authorities (supervisors of the covered bond issuers), rating agencies and citizens. The following consultation activities were conducted (IA, p. 81):

1. Public consultation on covered bonds, followed by a conference organised by DG FISMA (12 weeks, 76 responses) (the summary is available on-line);
2. Public hearing held by the EBA before publishing its 2016 report (no information about the participants or the number of responses is provided in the IA);
3. Feedback on the inception IA on covered bonds (4 weeks, 4 responses);
4. Stakeholder interviews and an online survey as part of the ICF study (106 organisations and 61 responses respectively);
5. Targeted stakeholder consultation, including the Expert Group on Banking, Payment and Insurance (two meetings).

The stakeholders were consulted on the recent trends in the European covered bonds market, the possibly more integrated EU covered bond framework, the options and the elements for a hypothetical EU covered bond framework. The stakeholders' views were reflected in the problem definition and the options assessment sections of the IA report. According to the IA (p. 88), the stakeholder input can be grouped into two categories: 1) advice to change the existing framework to address concerns of a prudential nature, coming from the European Systemic Risk Board (ESRB), EBA, ECB and to some extent from the national competent authorities in the Member States with well-developed covered bond markets and from rating agencies; 2) requests not to disrupt the existing well-functioning national systems, coming from Member States with well-developed covered bond markets and from issuers and investors alike. To include both types of stakeholder input, the Commission intends to define the structural features of the covered bonds in a directive, leaving room for national implementation. To specifically address the prudential concerns regarding preferential capital treatment, the Commission intends to make targeted amendments to Article 129 of the CRR (IA, p. 88). A synopsis of the stakeholder consultations is included in the IA (pp. 81-88), in line with the BR Guidelines.

Monitoring and evaluation

According to the IA (p. 74) and the proposed directive's explanatory memorandum, the Commission shall carry out an evaluation of the legislative package no sooner than 5 years after the date of transpositionof the directive. The IA identifies a set of benchmark costs and benefits that can be used in ex post evaluation (IA, pp. 74-75). According to the IA's executive summary, however, a first review of the new framework could be undertaken 2-3 years after its entry into force. According to Article 31 of the proposed directive, the Commission shall submit an implementation report 3 years after its transposition. No specific implementation plans or monitoring, evaluation and reporting arrangements are mentioned for the proposed regulation.

Commission Regulatory Scrutiny Board

The Regulatory Scrutiny Board (RSB) published a positive opinion with reservations on 12 March 2018. Its main criticisms were that the reasons for considering the 29th regime unattractive were unclear and seemed to overstate its disadvantages, and that the IA did not set out clearly the main elements of the minimum harmonisation approach. The IA does not contain a section explaining the modifications made to the report following the RSB recommendations, which is not in line with the BR Toolbox (Tool #12), but overall it seems to have responded to a great extent to the comments expressed in the RSB opinion.

Coherence between the Commission's legislative proposal and IA

The proposals appears to follow the IA's recommendations, in that they are based on the preferred option 2. According to the proposals' explanatory memoranda, the proposed framework consists of the directive and the regulation, which should be seen as a single package. According to the proposed regulation's explanatory memorandum, a regulation is the appropriate instrument, as the provisions replace those of Article 129 of the CRR and thereby achieve the same direct effect as the current regulation. This appears in line with the stakeholder consultation results and the 2016 EBA report, which recommended a three-step approach (IA, p. 28): 1) the development of a covered bond framework with the introduction of a new covered bond directive; 2) targeted amendments to the CRR relating to the preferential treatment, and 3) non-binding instruments to stimulate voluntary convergence in specific, less critical areas.

Conclusions

The IA provides a coherent problem definition and sets the corresponding general and specific objectives. The overall presentation of the IA's options is balanced and their alignment with the 2016 EBA advice and the 2017 Parliament resolution is clear. The impacts analysis focuses mainly on the costs and benefits of enhancing the CMU potential, i.e. developing covered bond markets in all EU countries, investor base diversification, improving cross-border investments and attracting investors from outside the EU. The costs and benefits of improving the coherence of EU prudential regulation with the structural characteristics of covered bonds is assessed qualitatively. The stakeholder views are reflected in the problem definition and the options assessment sections of the IA and the Commission appears to have made the effort to accommodate stakeholder input. However, some parts of the IA do not entirely follow the requirements of the Better Regulation Guidelines in that it does not set sufficiently specific and time-bound objectives and does not provide operational objectives under the preferred option. Furthermore, it does not assess any of the options in terms of their proportionality and does not check the subsidiarity compliance of the regulatory options. Finally, the IA does not contain a section explaining the modifications made following the RSB recommendations.

ENDNOTES

[1] For further information, see Delivorias A., Covered bonds – ripe for expansion?, EPRS, European Parliament, January 2015. Delivorias A., Covered Bonds – Issue and supervision. Exposures. EU Legislation in progress briefing (forthcoming).

[2] Such as: Directive 2009/65/EC on Undertakings for Collective Investment in Transferable Securities (UCITS); Bank Recovery and Resolution Directive 2014/59/EU; Capital Requirements Regulation (EU) 575/2013 (CRR); Solvency II Delegated Regulation (EU) 2015/35; Liquidity Coverage Ratio Delegated Regulation (EU) 2015/61 and European Markets Infrastructure (EMIR) Delegated Regulation 2016/2251.

[3] Report on EU covered bond frameworks and capital treatment, European Banking Authority, 2014 and Report on covered bonds – recommendations on harmonisation of covered bond frameworks in the EU, European Banking Authority, 2016.

[4] Resolution, Towards a pan-European covered bonds framework, European Parliament, 26 June 2017.

[5] Denmark, France, Germany, Italy, Spain and Sweden represent approximately 80 % of global covered bond issuance. The four largest markets (Germany, Denmark, France and Spain) accounted for almost two-thirds of the EU market in 2015.

[6] Bulgaria, Croatia, Cyprus, Estonia, Latvia, Lithuania, Malta, Romania and Slovenia.

[7] Report on Covered bonds in the European Union: Harmonisation of legal frameworks and market behaviours, ICF, 2017.

[8] Single Supervisory Mechanism (SSM) is the system of banking supervision that comprises the ECB and the national supervisory authorities of the participating countries.

[9] See the Platform for EU Interparliamentary Exchange (IPEX).

[10] ESN is a dual-recourse financial instrument on an issuer's balance sheet applying the basic structural characteristics of covered bonds to two non-traditional cover pool assets – SME bank loans and infrastructure bank loans. As ESNs are backed up by higher risk assets, they are subject to a separate IA, which is ongoing at the moment of writing.

This briefing, prepared for the ECON committee, analyses whether the principal criteria laid down in the Commission's own Better Regulation Guidelines, as well as additional factors identified by the Parliament in its Impact Assessment Handbook, appear to be met by the IA. It does not attempt to deal with the substance of the proposal.

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