DRAFT REPORT

on Towards a pan-European covered bonds framework
(2017/2005(INI))

Committee on Economic and Monetary Affairs

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MOTION FOR A EUROPEAN PARLIAMENT RESOLUTION

on Towards a pan-European covered bonds framework (2017/2005(INI))

The European Parliament,

– having regard to the EBA Report of 20 December 2016 on Covered Bonds: recommendations on harmonisation of covered bond frameworks in the EU (EBA-Op-2016-23),

– having regard to the Commission Consultation Document of 30 September 2015 on Covered Bonds in the European Union and the undated Commission document “Summary of contributions to the public consultation on ‘Covered Bonds’”,


– having regard to the EBA Opinion of 1 July 2014 on the preferential capital treatment of covered bonds (EBA/Op/2014/04),

– having regard to the EBA Report of 1 July 2014 on EU covered bond frameworks and capital treatment: response to the Commission’s call for advice of December 2013 related to Article 503 of the Regulation (EU) No 575/2013 and to the ESRB Recommendation E on the funding of credit institutions of December 2012 (ESRB/12/2),


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thereof,


– having regard to Rule 52 of its Rules of Procedure,

– having regard to the report of the Committee on Economic and Monetary Affairs (A8-0000/2017),

A. whereas covered bonds (CBs) are instruments with a long-established track record of low default rates and reliable payments;

B. whereas EU law lacks a precise definition of CBs;

General observations and positions

1. Stresses that domestic and cross-border investments in CBs work well in EU markets under the current legislative framework; emphasises that product diversity should be maintained;

2. Warns that a mandatory harmonisation of national models or their replacement by a European one could lead to unintended negative consequences for markets whose current success relies on CB legislation being embedded in national laws; insists that European legislation be limited to a principles-based approach which establishes the objectives but leaves the ways and means to be specified in the transposition to national laws;

3. Calls for a clear definition of CBs in a European Directive; insists that the definition for securities henceforth called ‘covered bonds’ must not fall below the standards currently set by Article 129 of the CRR; requests that securities incompatible with this definition but compatible with Article 52(4) of the UCITS Directive are properly defined in the same directive under a name clearly distinct from ‘covered bonds’; suggests that this
name may be ‘European Secured Notes’; (ESNs);

**Defining CBs, ESNs and their regulatory framework**

4. Calls on the Commission to propose a Directive defining CBs and ESNs, including all the following common principles:

a) CBs and ESNs are fully backed by a cover pool of assets;

b) National law ensures dual recourse, i.e. the investor has:

i) a claim on the issuer of the security equal to the full payment obligations attached to it, and

ii) an equivalent priority claim on the cover pool assets (including substitution assets and derivatives) in the event of the issuer’s default.

Should these claims be insufficient to fully meet the issuer’s payment obligations, the investor’s residual claims must be at least pari passu with claims of the issuer’s unsecured creditors;

c) Effective segregation of all cover pool assets is ensured in legally binding arrangements which are easily enforceable in the event of insolvency or resolution of the issuer. The same will hold for all substitution assets and derivatives hedging risks of the cover pool;

d) The CB is bankruptcy remote, i.e. it is ensured that the issuer’s payment obligations are not automatically accelerated in the event of the issuer’s insolvency or resolution;

e) Overcollateralisation (OC) is applied to the cover pool. By an extent to be determined in national law, the value of all cover pool assets must always be greater than the net present value of outstanding payment obligations. The value of cover pool assets is at all times to be determined on the basis of market prices when market prices are available and on the basis of face values adjusted for market conditions if no market prices are available;

f) European or national law defines maximum loan-to-value (LTV) parameters for cover pool assets in a way that ensures that the removal of cover pool assets on the grounds of insufficient LTV occurs only if they are replaced by assets of at least the same market value. The removal of cover pool assets in breach of LTV limits should not be mandatory, as maximum LTV requirements should only determine the contribution of any given cover pool asset to the coverage requirement;

g) A part of the cover pool assets or liquidity facilities is sufficiently liquid such that the payment obligations of the CB or ESN programme can be met for the next six months;

h) National law provides for a robust special public supervision framework by
specifying the competent authority, the cover pool monitor and the special administrator, along with a clear definition of the duties and supervisory powers of the competent authority, to ensure that:

i) issuers have qualified staff and adequate operational procedures in place for the management of the cover pools, including in the event of stress, insolvency or resolution,

ii) the features of specific programmes meet the applicable requirements both prior to issuance of and until maturity of the security.

The duties and powers of the competent authority and the special administrator in the event of the issuer’s insolvency or resolution must be clearly defined;

i) The issuer is required to disclose at least biannually aggregate data on the programme to a level of detail that enables investors to carry out a comprehensive risk analysis. Information should be provided on the credit risk, market risk and liquidity risk characteristics of cover assets, on counterparties involved in the programme and on the levels of legal, contractual and voluntary OC;

5. Calls on the Commission to include in the Directive’s definition of CBs the following additional principles:

a) The security is fully collateralised by assets defined by Article 129(1)(a)-(f) of the CRR and satisfies the additional requirements of Article 129(2) and (7) of the CRR;

b) The maximum LTV parameters for mortgages are set by European law in such a way that they do not surpass the LTV ratios currently fixed in Article 129 CRR, but are subject to regular review and adjustment in line with independent assessments (stress tests) of pricing conditions which might prevail in the relevant real estate markets under stress;

c) The maturity of the CB cannot be extended, except in the event of insolvency or resolution of the issuer and with approval by the competent supervisory authority;

6. Emphasises that the risk weights assigned to CBs in European legislation must reflect market assessments of underlying risks; underlines the need to eliminate market distortions by ensuring that the same applies to all other types of securities that enjoy preferential regulatory treatment;

7. Recommends that market access barriers for issuers in developing CB and ESN markets outside the EEA be removed by providing equitable treatment to CBs and ESNs from issuers in third countries, provided their legal, institutional and supervisory environment passes a thorough equivalence assessment by a competent European institution;

8. Calls for a revision of EU financial services legislation with the aim of granting CBs adequate regulatory preference over ESNs;

Supporting market transparency and voluntary convergence
9. Welcomes improvements in CB rating methodologies and the expansion of the rating markets for CBs;

10. Welcomes market initiatives to develop harmonised standards and templates for disclosure (e.g. the HTT) to facilitate the comparison and the analysis of differences between CBs across the EU;

11. Supports the development of EBA recommendations for market standards and guidelines on best practices; encourages voluntary convergence along these lines;

12. Encourages the regular execution of stress tests for CB programmes and the publication of stress test results;

13. Instructs its President to forward this resolution to the Council, the Commission and the European Banking Authority.
EXPLANATORY STATEMENT

Covered bonds (CBs) have always been, ever since their invention more than two centuries ago, a very specific asset class in many ways. Long-established instruments in the financing structures of several Member States, they have proved to be reliable investments for a variety of financial institutions and a convenient and efficient funding option for issuers. They rely on very strong structural characteristics such as the dual recourse, the high quality cover pools (consisting almost exclusively of mortgage loans (85%) and public debt instruments (15%)) and the segregation of cover pool assets. Investors’ trust is reinforced by CBs being subject to special public supervision.

The extraordinary degree of safety and liquidity which CBs have exhibited over decades prevailed even in times of severely troubled financial markets, e.g. during the last ten years. This has led to the recognition of CBs as assets whose holding warrants preferential regulatory treatment under the EU financial services legislation.

A fairly vague description of the asset class given in Article 52(4) of the UCITS Directive serves as the “definition” of covered bonds in EU law – although the text falls short of referring to the asset class as “covered bonds”. Subsequent EU legislation has built on this definition to

- grant a favourable treatment to CBs held by banks if the CBs meet certain precisely worded requirements under Article 129 of the CRR;
- included CBs that meet certain specific conditions in the list of assets recognized as Level 1 High Quality Liquid Assets under the Liquidity Coverage Requirement Delegated Act; and
- excluded CBs, up to the collateralised part, from the bail-in when a bank is under resolution, under Article 44(2) BRRD.

The success of CBs can be pinned down to essentially two factors:

(1) economically, to the existence of collateral in the form of high quality assets of a long-lasting nature which are easily valued and repossessed, i.e. mostly mortgages and government bonds

(2) institutionally, to the existence of a legal and supervisory framework which guarantees dual recourse for the investor, the segregation of the cover pool and special public supervision.

From the perspective of European legislation, it is interesting to note that the CB “definition” in Article 52(4) of the UCITS Directive essentially requires CBs to satisfy (2), but does not

impose the high quality requirements on cover pool assets as expressed in (1). Rather, admissible cover pool assets are determined by national laws. In all Member States these laws are focused on mortgages and public sector loans, but some Member States also provide for the inclusion of other, possibly riskier assets.

From a perspective of systemic financial stability, (1) seems indispensable. To exempt CB creditors from the bail-in tool of the BRRD can only be justified if CBs are different from other debt instruments on the grounds of extremely low default risk. Absence of significant default risk is also key in including CBs among the Level 1 liquid assets in the LCR Delegated Act and in granting investors higher exposures for these type of exposures than for other transferable securities or money market instruments.

The EBA in its 2016 report speaks out clearly against granting preferential regulatory treatment to CBs whose cover pools include more risky types of assets, e.g. SME loans, infrastructure loans or loans to other non-public debtors. The EBA is also sceptical towards movable assets such as ships (and aircrafts), which, if moved out of the EU, may be difficult to repossess.

On the other hand, given the successful role CBs have played and continue to play in financing mortgages or public sector loans, it is suggestive to make the institutional framework (2) available also to riskier types of assets such as SME finance or infrastructure investment. A sound legal framework providing for dual recourse, segregation of cover pools and special public supervision may provide – for both issuers and investors – an attractive alternative to securitizations or other forms of debt finance. Contractual arrangements underlying securitizations are often costly to set up, difficult to monitor and subject to legal disputes in the case of issuer default or resolution.

More transparency, more public supervision, and more legal certainty can be achieved by extending the institutional principles of CBs (2) to debt instruments which finance important and growth-enhancing economic activities (e.g. SME or infrastructure investments). But financial stability must not be compromised. Exemptions from general capital requirements in banking regulation or from the bail-in tool should not be granted to securities whose collateral does not satisfy (1).

Therefore, your rapporteur proposes a European directive which clearly defines and distinguishes two types of assets: Covered Bonds (CBs) and European Secured Notes (ESNs). Common to both types of securities would be the principles of a legal and supervisory framework (2). The label “covered bond” would be used if and only if the securities also satisfy (1) and, hence, only CBs would be able to qualify for preferential regulatory treatment. To avoid unnecessary disruptions in smoothly working CB markets, your rapporteur further suggests to define CBs building closely on Article 129 of the CRR¹.

The CRR is silent on the admissibility of CBs with conditional maturity extensions (soft bullets and conditional pass-through (CPT) structures). These types of CBs have greatly increased in recent years. While maturity extensions may serve as useful contractual provisions for predictability and for risk management, particularly in cases of issuer default or resolution, they clearly shift part of the risks from the issuer to the investor. This may, if no attention is paid thereto, cause broader systemic risks. Preferential regulatory treatment should therefore not be granted to CBs with maturity extensions except for cases of default or resolution, i.e. for cases in which the alternative to a maturity extension would be a default of the issuer on the

¹ This limits cover pool assets to mortgages, public loans or assets with state guarantees. Deviating slightly from the CRR, ships should not qualify for CBs.
CB. Moreover, to protect investors and safeguard financial stability, the issuer should not have discretion in the triggering of maturity extensions. Rather, any extension of CB maturities in the case of default or resolution should be contingent on approval by the competent supervisory authority.

Covered bond regimes are deeply rooted in national insolvency laws. Cover pools and the dual recourse principle are safeguards against insolvency of the issuer, where the legal proceedings necessary to satisfy creditors’ claims against an illiquid CB issuer depend on national laws and vary considerably between Member States. European legislation should cause no disruption for frameworks which are well embedded in national law and which have enabled CB markets to operate smoothly and successfully over decades. This is why European legislation should be limited to a directive which sets the principles of CB and ESN markets. The development of technical standards should be left to the competent national supervisory authorities after in response to the transposition to national law.

Maximum loan-to-value ratios for mortgages form an important part of the eligibility criteria laid out in Article 129 CRR. Given the substantial price fluctuations which some real estate markets have experienced, LTVs must be considered a defining property of collateral for CBs which enjoy regulatory preference and not a technical standard that might be decided freely by Member States. Your rapporteur therefore proposes to continue setting maximum LTVs by European legislation and to monitor closely if these LTVs are in line with independent assessments of pricing conditions which might prevail in the relevant real estate markets under stress.

Finally, any action at the European level should also take into account three important developments not mentioned so far:

- Strong market-led initiatives are already in progress. For example, the Covered Bond Label developed by the issuer community in cooperation with investors and regulators has been agreed in 2013 and has reached in 2016 a coverage of 60% of outstanding CBs worldwide. Where those initiatives exist, they should be encouraged and either replace public intervention or be the basis for optional or mandatory standards. In particular, the Harmonised Transparency Template established since 2016 under the CBL could be a basis for common disclosure standards applicable to CB issuers.
- CBs are gaining popularity in a number of non-EU countries, e.g. Australia, Canada, Chile, New Zealand, Singapore, South Korea, Turkey and Russia. Other major jurisdictions (including Brazil, India, Japan, Mexico, Morocco, Panama, Peru, South Africa and the United States) may soon follow suit. A careful approach of European legislation limited to basic principles combined with sufficient flexibility for the idiosyncrasies of national laws and legacies will allow to integrate European CB and ESN markets with similar markets for similarly safe financial products elsewhere in the world and will therefore reinforce the long-run prospects for economic growth in the EU and in third countries. Moreover, EU standards would have the potential to function as a blueprint for developing CB markets worldwide.
- The market has been living, to some extent, under public support in recent years. The ECB asset purchase programme (again most recently via the CBPP3 since October 2014) has had a significant effect on primary and secondary markets of CBs, contributing, along with regulatory treatment, to increasing issuance of CBs since 2013. However, this has caused significant crowding out of private investors and stakeholders have warned that this crowding out may continue and eventually destroy the market unless the ECB disengages from CB markets in the near future. Any legislative or
regulatory initiative should therefore be carefully weighted. Significant change of rules would create uncertainty for markets which need to win back investors they have lost. Since 2015, the Commission’s **Capital Markets Union initiative** (in particular via its public consultation on CBs of September 2015) has looked at enhancing CB markets in Europe with due respect to national preferences and frameworks. This is important since the success of the asset class has relied on national frameworks developed over decades and tailored to the local long-term financing needs, banking or capital market structures and risk appetite. Those particularities and flexibilities are to be appreciated and cultivated for European CB markets to continue leading in the world.