

European Covered Bond Council (ECBC)

CB Directive Implementation Note

Background information

The EMF-ECBC welcomes the objectives of an EU Covered Bond Legislative Framework¹ to promote further integration of the EU's financial markets and reinforce the Capital Markets Union (CMU), and is following very closely the implementation process of the Covered Bond Directive. Against this background, the ECBC decided to establish (in April 2019) an Implementation Task Force (TF) which consists of national expert representatives from almost all European covered bond jurisdictions, as well as from some non-European countries such as Canada and Singapore. This TF seeks to monitor the legislative implementation processes and feed into the implementation debate given its technical capacity, in order to support the identification and definition of balanced, effective and shared interpretations of sections of the legislative framework. We believe this will be beneficial to covered bond stakeholders at both European and Global levels. This is particularly important considering that the Directive proposed by the European Commission is founded on high level principles which may give rise to different interpretations across jurisdictions.

Concretely, the goal of the TF is to act as platform at European level for the interpretation of specific provisions of the Covered Bond legislative package and, where possible and desirable, provide shared interpretation guidelines in order to optimise harmonisation where possible without adversely affecting well-functioning markets. As a market think-tank, the ECBC - through the TF - intends to support the principle-based approach of the legislative package and to provide material to country representatives that can be used when implementing the Directive at national level. Moreover, the TF also provides stakeholders with a network of experts on covered bonds in different jurisdictions who can offer support in the clarification of issues with respect to the legislative package and possible impact on the market. Concerning the governance of the TF, the ECBC Steering Committee has the final say on both the level of confidentiality and the degree of usage/publication of any documents produced by the TF.

Modus operandi

As a starting point, the TF conducted a gap analysis to develop an overview of the deviation of the existing national legal frameworks compared with the new Directive and Regulation. The TF members also identified a number of articles where a more detailed exchange of views was required, with subsequent discussions revealing that there could be different understandings and interpretations possible of the phrasing of the Directive and the Regulation which may require further clarification.

Moreover, three key areas were identified where the TF considered that further reflection is useful and maybe even necessary, namely regarding: 1) the treatment of derivatives; 2) the liquidity buffer rules and 3) the conditions for extendable maturity structures. Against this background, three interpretation sub-groups were created within the TF to provide more clarity on interpretations of the new provisions and, where relevant, to seek to come up with ideas on how best to address such issues.

¹ For reference, please find here links to the [Directive \(EU\) 2019/2162](#) and [Regulation \(EU\) 2019/2160](#).

Legislative Context

In the history of this asset class, the legislative framework in which covered bonds' dual recourse mechanism is nestled has been the key element guaranteeing crisis management, robustness of the product and anticyclical characteristics.

Investors have long considered this asset class as a safe harbour mainly because of (1) the strength and the quality of the collateral, (2) the robustness of the dual recourse mechanism and (3) its implicit strategic importance from a macroprudential and financial stability perspective.

Over the years, the covered bond model in every jurisdiction has been designed to reflect the best possible qualitative standards and the structures have been adapted to very heterogeneous legal and market best practice landscapes existing in Europe and beyond. Legal details can differ from one jurisdiction to another as the laws in countries are different; however, overall the national legislator has provided the highest level of quality and robustness to secure investor confidence.

The ECBC has been instrumental during the process towards more transparency and harmonisation by providing full transparency on the legal characteristics of covered bonds, by creating a comparative database where investors can analyse and compare legal frameworks when performing their due diligence. This database is available at www.ecbc.eu and is accessible also through the [Covered Bond label website](#).

The Covered Bond Label, which was set up by the ECBC in 2012, is intended to result in multiple benefits with an enhancement of the overall recognition of and trust in the asset class. The Label facilitates access to relevant and comprehensive information for investors, regulators and other market participants, and demonstrates the support and the determination of the covered bond community to tackle the challenges arising from the financial crisis. It also underlines the industry's active engagement in the maintenance of the high quality of the collateral assets, the improvement of transparency, and eventually, the promotion of liquidity. The Covered Bond Label Initiative acted as quality benchmark and allowed over the years a strong European and global convergence of market best practices and legislative frameworks in the covered bond space.

On top of the legislative information, the Covered Bond Label provides with the Harmonised Transparency Template (HTT) very detailed information on the cover assets in the cover pool. Very recently the ECBC developed a new additional IT tool on the Covered Bond Label website to capture key information on the asset side within the cover pool reported in the HTT to present data using pie charts and histograms. We expect this to facilitate further investor due diligence and enable comparative analysis of different issuers in different countries. In essence the new HTT tool provides an informational bridge to represent cover pool data until now available only in the spreadsheets of the HTT in a standardised and visually appealing format.

The Covered Bond Industry has strongly supported the creation of a common European framework, enabling the introduction of covered bonds in jurisdictions where capital markets are now developing, benefiting from the long existing experience of traditional covered bond markets. However, at the same time, the covered bond industry always called for a principle-based approach in order to respect the specific measures taken in national contexts to secure the best possible quality for investors and prevent the well-functioning covered bond market to be adversely affected unintentionally by the Covered Bond Directive. Mortgage markets, insolvency laws, bankruptcy laws and foreclosure and bankruptcy remoteness best practices are deeply rooted in national contexts. Therefore, in certain areas, objectively it is very difficult to find common denominators or common solutions because the technical landscape is rightly based on different legal basis.

These differences will challenge the possibility of finding efficient solutions quickly which are appropriate to all markets and a wrong choice could disrupt the status quo which has always secured the smooth functioning of this asset class through many crises in its 250-year history.

During the course of these months of intense work, our legal experts have identified a few areas in the Directive, which require strong cooperation among all market participants in order to agree a common interpretation and provide not only clear and practical guidelines to national legislators in the implementation process but also transparency and clarity to investors.

Interpretation Areas to be analysed

The TF has identified the following areas which require particular attention in order to guarantee harmonisation and operational efficiency of the implementation process and prevent potential market disruption in existing and well-functioning markets.

Derivatives (Article 11 with additional impact for Article 12 and Article 15)

Derivatives are an extremely important part of covered bond structures as they hedge interest rate and currency risk which can exist between cover pool assets and covered bonds. The way hedging is used by covered bond issuers may depend on their business model and their group structure. Best practice includes (among other things) that: (i) these derivatives are only used for hedging and can survive the insolvency (or resolution) of the issuer and/or counterparty; (ii) payments owed to the counterparty are secured by the cover pool; (iii) the counterparty has an obligation to provide the cover pool with collateral in certain situations; and (iv) only certain eligible institutions may provide these derivatives.

In this respect, therefore, the interpretation group believes that the determination of what constitutes “hedging” (as required by Art. 11) should continue to be evaluated on a pragmatic basis without having a direct interaction with accounting rules, and that periodic adjustments to derivative terms should be conducted in a reasonable time but avoid undue operational burden.

Art. 11 stipulates that derivative contracts cannot be terminated upon the insolvency or resolution of the credit institution that issued the covered bonds, in order to preserve the insolvency-remote nature of the derivatives. With regard to the eligibility criteria, they must be dynamic to reflect changing economic times but avoid a “cliff risk” by not including for instance minimum ratings requirements. This article should be implemented with consideration of the BRRD, specifically Arts. 44 and 79, which gives authorities power to manage derivatives during the resolution of financial institutions.

Art. 12 requires that any collateral received in connection with derivative contract positions should be segregated in the same way as cover assets. While some jurisdictions have methods for including collateral for derivatives in their cover pools, others do not. Countries drafting new rules to accommodate this requirement may want to specify that the value of such collateral is excluded from the coverage tests to avoid other subsequent impacts to their covered bond programmes, such as the need to record a corresponding liability or breaching substitute asset limits.

Regarding the valuation of derivatives for the purposes of coverage tests (Art.15), valuation methods should be consistent with the methods used to value assets and liabilities of the cover pool. Derivatives are often valued on a net present value basis, and countries with net present value coverage tests may therefore naturally include derivative values in their calculations. Countries which calculate coverage on a nominal basis may decide for the purposes of Art. 15 that some or types of derivatives are valued at 0 to prevent a distortion of the calculation. Otherwise, in the case of nominal tests, including the mark-to-market on the asset side could require an adjustment to the value of the liabilities.

Liquidity buffer (Article 16) overlapping liquidity requirements

The main objective of the TF in this area was to investigate possibilities that ensure that the liquidity buffer requirements introduced in the Directive do not create overlapping liquidity requirements covering the same outflows. This specifically relates to the 180-day liquidity buffer requirement in the Covered Bond Directive and the already existing LCR requirements.

The ideal solution ensures that the intended liquidity risk protection for covered bond investors by the 180-day liquidity buffer in the Covered Bond Directive can be achieved, whilst in parallel making sure that prudent liquidity management is carried out in line with the LCR regulation.

The Covered Bond Directive recitals (23) specify that the cover pool liquidity buffer is introduced to address risks of liquidity shortage within the covered bond programme. It is further specified that the liquidity buffer for the cover pool seeks to mitigate liquidity risks specific to the covered bonds. Member states should be able to allow

an appropriate interaction with liquidity requirements established by other Union legal acts that serve different purposes. The Directive specifically states that *“such decisions should avoid subjecting credit institutions to an obligation to cover the same outflows with different liquid assets for the same period”*.

In order to achieve a harmonised EU/EEA approach two issues need to be addressed. The first is to avoid overlapping liquidity buffer requirements, the second is to ensure that there is no need for additional (non-cover pool) assets to cover covered bond related outflows. The former issue is already temporarily addressed in the Covered Bond Directive by allowing for national discretion (Art. 16 (4)) to solve the issue of the overlapping 30 days until an amendment of the LCR Delegated Act becomes applicable. This allows for a solution implying that, on a given date, the LCR requirement would consider the net liquidity outflow of the following 30 days, while the liquidity buffer introduced in the Covered Bond Directive would consider the net liquidity outflow from day 31 to day 180 (i.e. 150 days). This temporarily removes the need for two parallel liquidity reserves covering the same outflow (inside and outside the cover pool).

The latter issue is more complicated and probably best resolved by changes to the LCR Delegated Act or an official interpretation of the same. One key element in achieving the intended purpose is to make sure that net outflows pertaining to covered bonds in the LCR can be covered by liquid assets inside the cover pool. This will protect covered bond investors by making sure that the liquid assets are included in the cover pool in case of a separation of the covered bond programme(s) from the credit institution’s general estate.

Extendable Maturities Derivatives (Article 17)

As explicitly recognised by the Covered Bond Directive (Recital 24) the issuance of covered bonds subject to extendable maturity structures can be a way to address liquidity risk. These structures already exist in a number of Member states and it is important to establish the conditions under which such structures are allowed, ensuring they are not too complex and do not expose investors to increased risk. Extension should not be a discretion of the issuer. Extensions could also facilitate the orderly winding-down of credit institutions issuing covered bonds, allowing for extensions in the case of insolvency or resolution to avoid a fire sale of assets.

According to Art. 17, maturity extensions are an option for national legislators in the implementation of the Directive and national legislators are required to define the objective triggers for such maturity extension. The interpretation group investigated the current extension mechanisms in various countries with the aim of finding a common denominator for objective triggers which could be a blueprint for all jurisdictions. For this purpose, the group assessed certain elements such as issuer default, failure to pay, acceleration of the covered bonds towards the issuer and various other factors that could potentially serve as a common denominator for extension on the original (scheduled) maturity date.

The assessment revealed that some differences exist between the various jurisdictions. However, the group was able to identify two **alternative** common features, which could be used as anchor points for the definition of objective triggers for extension:

- A failure to pay by the issuer with respect to principal on the original (scheduled) maturity date (taking into account any applicable grace period); or
- Designation by the supervisor or the cover pool administrator that extension is required.

Such triggers are objective and eliminate any discretion of the issuer in the maturity extension and could potentially be considered as common objective triggers by all jurisdictions. However, legal and contractual matters with these proposals will need further investigation if the concept is adopted. Moreover, further investigation is required on whether or not other existing triggers (such as breach of asset cover tests or amortisation tests or other regular events of default) can be considered as well. In addition, the group found that more stringent triggers such as insolvency/resolution, as were proposed before the adoption of the Directive by the European Parliament’s ECON Committee, are not feasible within all current structures. Since a failure to pay on a capital market debt instrument would have an enormous impact on the reputation of the bank involved, the inclusion of a failure to pay trigger would have similar outcome as an insolvency or resolution one. Furthermore, in some jurisdictions, some consequences of going into a maturity extension are set out in the national legislation or the programme documentation.

In its consultation response from January 2019, the ECB expressed concerns on the discretion of the issuer to trigger extension, which would hinder harmonisation. The group strongly believes that the requirement of a failure to pay or supervisory action should address these concerns, since no issuer would voluntarily opt for a failure to pay on a capital market instrument.

Conclusion

We invite the European Commission and Member States to liaise with the ECBC Implementation TF and seek clarity and harmonisation of key interpretation areas of the Covered Bond Directive. The ECBC is ready to organise a workshop for an exchange of views on the implementation processes at national levels.

ECBC Reaction to COVID-19 Crisis

The COVID-19 pandemic and the resulting containment measures are shifting our society and economy towards an entirely new paradigm which is necessitating a complete and fundamental rethink of our economic pillars and social attitudes. This crisis has profoundly disrupted people's lives and the entire economy. Global demand, supply chains, labour supply, industrial output, commodity prices, foreign trade and capital flows have all been affected. The pandemic struck the European economy when it was on a moderate path and still vulnerable to new shocks. Given the severity of this unprecedented worldwide shock, it is now quite clear that the EU has entered the deepest economic recession in its history.

The EMF-ECBC being mindful of the role our Industry can play in supporting efforts to address this and future economic challenges, has established an Emergency COVID 19 Task Force and has put at the complete disposal of the European Institutions its intelligence, expertise and network to support actions responding to this unprecedented crisis. To this end, the EMF-ECBC is determined to act as a market catalyst and think-tank at European and global levels with a view to fostering and coordinating market and policy actions focused on immediate measures to mitigate adverse systemic impacts.

The work of the COVID-19 Task Force is already underway to, in the first instance, analyse the impacts on mortgage and covered bond markets, compile relevant national, European and international measures and gather critical statistics ([see here for dynamic reporting document](#)). Using this intelligence, the Task Force will soon move into a second stage, during which it will identify market best practices and solutions with a view to delivering market coordination and support to a future recovery plan. Crucial to this will be a dynamic dialogue with EMF-ECBC members in Europe and globally, as well as European and international institutions and organisations.

The Task Force is composed of retail, funding and investment bank, law firms, rating agencies representatives appointed by the EMF Executive Committee and ECBC Steering Committee for each Member jurisdiction and meets virtually every week and will do so for as long as is necessary.

In particular, we are acutely aware of and concerned about the potential consequences of this outbreak on the economic well-being of each and every European citizen in terms of changes in their income and ongoing living costs, as well as the potential impacts on the entire value chain, the functioning of capital markets and the ability of investors to conduct due diligence. Against this background the **European Mortgage Federation - European Covered Bond Council (EMF-ECBC)** stands ready to act in the interests of consumers, lenders and investors to help secure financial stability and stimulate socio-economic recovery.

Eligibility criteria (Article 6 Covered Bond Directive) & COVID 19 impact

Against this background and the severe impact on the mortgage origination supply chain, we would like to stress that the COVID 19 crisis could open the debate around Art. 6 and eligibility criteria of collateral and how covered bonds could help the recovery of the real economy. We would like to stress the paramount importance of guaranteeing the high quality of the collateral and full transparency and legislative clarity for investors. Any watering down of quality could dramatically impact the functioning and performance of the asset class.

In this context, we would like to underline the importance of considering only high-quality traditional asset classes in the covered bond framework and we propose the introduction of European Secured Notes as an alternative for non-traditional collateral assets, such as SME loans.

- *Covered bonds supporting the recovery through long term financing of mortgage, public sector & ESG assets*

Covered bonds offer huge potential to mobilise private capital to support the recovery from the current crisis. As indicated above, the covered bond is a finance mechanism linking financial markets and the real economy. The macroprudential value of this tool is deeply rooted in the high-quality nature of the collateral and the legal infrastructure protecting investors with a dual recourse mechanism. The focal point of this mechanism is the mortgage system and the lien to a real estate guarantee or public sector financing guaranteed by the State or other local authorities.

For centuries, the mortgage finance mechanism has been used to secure private capital inflows by providing a solid legal framework to protect long-term investors with a legal-financial safe harbour to boost private and public investments in relation to strategic objectives.

Covered bonds are one of the safest and most successful long-term financing instruments in use in Europe and played a central role in the crisis management toolkit of banks during the financial crisis by providing a safe and reliable source of funding. It is important to note here the fact that covered bonds are also recognised as eligible assets for the liquidity facilities of the ECB, which is crucial to preserve and, if possible, enhance the ability of credit institutions to weather crises such as the present one.

In many European countries, covered bonds play a key role not only for the funding of mortgages, but also for the refinancing of loans to the public sector (public entities, national, regional or local authorities). Around a third of the total outstanding loans to local government in countries like France, Germany and Spain are re-financed via the issuance of public sector covered bonds. There is evidence that huge amounts of public sector spending will be required in order to secure the recovery of the EU economy, not limited to the area of health and hospitalisation services.

Public sector covered bonds can secure private capital flows to the public sector and in doing so complement the actions already taken at EU and national levels. Mitigating the significant impacts of EU and Member States' measures on public debt levels, public guarantee schemes can also be used to mobilise private investors. Exposures to the real economy guaranteed by central or regional governments, by local authorities, public sector entities, multilateral development banks or international organisations are cover pool eligible and therefore suitable for covered bond funding. The major effect consists of private investors alleviating public budgets while ensuring continuous funding of businesses and households.

The rooting of the covered bond product in a dedicated legislative framework at EU level in 2019 crowns a series of significant achievements in developing the European Single Market, reinforcing financial stability in financial markets and supporting the concrete implementation of the Banking Union and a Capital Markets Union (CMU). This framework also represents a clear legislative benchmark at a global level. Indeed, the recognition of the macro-prudential value of this instrument by the Basel Committee in 2010 provided an impetus for global development, especially in emerging countries such as Brazil, Malaysia, Indonesia, Morocco, Turkey, South Africa, but also in established economies such as Australia, Canada, South Korea, Japan and Singapore.

- *European Secured Notes providing financing for SMEs and green & infrastructure assets*

A key challenge and priority of the recovery of the European economy will be maintaining financing of Europe's businesses. It will be extremely important to identify practical and operational long-term solutions to secure liquidity especially to SMEs.

Building on the success of the covered bond product as described above, the EMF-ECBC has been working on a market initiative to create a new pan-European dual-recourse long-term funding instrument called the European Secured Notes (ESN). This instrument would allow for the financing of asset classes beyond the traditional covered bond collateral types of mortgages and public sector assets such as SMEs and/or

green/infrastructure assets. This initiative combines existing techniques and market best practices for the establishment of a funding solution for lenders that is also accessible in a stress scenario.

One of the key success factors of traditional covered bonds is the common adoption of the same set of micro foundations and technology, in particular in terms of eligibility criteria, definitions, legal infrastructure and public supervision, risk parameters, data disclosure and IT solutions across European countries. If correctly implemented, supported by a minimum level of regulatory recognition as a very high-quality product under a clear legislative and supervisory framework, ESN could replicate the contribution of covered bonds to ensuring financial stability and access to finance for SMEs during this time of crisis.

On several occasions, the ESN project has been welcomed by institutions such as the European Central Bank, the European Commission, the European Investment Bank, the European Banking Authority and several national regulators.

We are ready to take action with our specially dedicated ESN Task Force and support the introduction of ESN across European markets, based on a new, distinct framework for this instrument. The financing of private sector business is key to the recovery of the European economy after the pandemic.