1.9 THE TRANSPOSITION OF THE COVERED BOND DIRECTIVE: TAKING STOCK

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INTRODUCTION

Eight years have passed since the European Banking Authority (EBA) noted the need for convergence of covered bond frameworks in the European Union (EU), to strengthen the covered bond market and ultimately provide financial stability. The ensuing principle-based Covered Bond Directive (CBD) was approved and published five years later in 2019, after long discussions and hard negotiations among European authorities, in an attempt to harmonise the national legislations of 27 EU member states, whilst accommodating sometimes contrasting markets needs and practices. The journey came to a successful end in 2022, the first year to see the new CBD transposed and in force in each and all national legislations.

The principle-based approach meant focusing on what was deemed as fundamental to the concept of covered bonds, while allowing for specificities of each of the existing national markets. Or, in other words, enhancing comparability, transparency and global recognition, while ensuring continuity of well-functioning domestic markets with which investors developed familiarity over the years.

In concrete, while dual-recourse, asset segregation, bankruptcy remoteness, public supervision, and the existence of a liquidity buffer, are examples of principles deemed as fundamental to be preserved and adopted, and were thus embedded in the CBD, elements such as maturity extension triggers, liquidity buffers, over-collateralisation (OC) and labelling, were thought to be best left to member states to specifically decide upon. Some of these country-specific elements have therefore been implemented with slight differences, which this chapter will analyse. It will also have a look at how the transition has played out in the primary and secondary covered bond markets.

TRIGGERS FOR EXTENDABLE MATURITIES

As part of the harmonisation effort, the CBD introduced for the first time in European-wide legislation the concept of extendable maturities, and in particular the need to harmonise the various extension options many covered bond programmes had contractually introduced. To assure investor protection, art.17 of the CBD clearly outlines the requirements issuers need to meet to be able to issue covered bonds with extendable maturities. Namely, the CBD requires Member States to include objective triggers specified in national law, and not at the discretion of the issuer, as conditions for covered bonds to extend.

Looking at how the extension features have been transposed into national covered bond frameworks, we can group the triggers into two main groups: (i) countries where the extension is a tool available for the covered pool administrator to avoid, or delay, the insolvency of the issuing entity, and (ii) countries where the extension can occur, or be decided upon, prior to the insolvency of the issuing bank, and will be triggered simply via non-payment of principal or interest on the covered bonds, even if still subject to conditions. It is not surprising that each Member State has identified slightly different triggers; finding one solution fits all would have been arduous mainly due to the fact that across Member States we have at least three covered bond issuance models: ring-fencing on balance sheet, specialist banking model and SPV guarantor structure.

LIQUIDITY BUFFER

Linked to the maturity extension triggers is the calculation of the liquidity buffer while art.16 comma 2 of the CBD prescribes how the liquidity buffer should be calculated stating that the cover pool liquidity buffer shall cover the maximum cumulative net liquidity outflow over the next 180 days, discretion was left to the national regulators to assess if the expected or the extended maturity date should be considered when including principal payments in the programme outflows. We focused our analysis on the top 12 Member States by covered bond issuance volumes and can report that only 2 countries being Germany and Denmark include covered bond principal payments as outflows at all times in the liquidity buffer calculation while the other ten all allow issuers to calculate the liquidity buffer using the extended maturity date in case of soft bullet or conditional pass-through covered bonds.

MINIMUM OVERCOLLATERALIZATION

Another requirement that was left to transpose at the national regulators' discretion was the minimum overcollateralization amount. Regulation (EU) 2019/2160 allows national regulators to set the minimum level of overcollateralization between 2% and 5%. Our analysis shows that various Member States have introduced distinct levels of overcollateralization for different types of cover pool assets, for example in Germany, the nominal overcollateralization required is 2% if the cover pool assets are either mortgages or public sector assets while for shipping and aircraft cover pools the overcollateralization requirement in 5%. Focusing on cover pools backed by residential mortgages, out of the 12 jurisdictions assessed, Denmark, Germany, Sweden, Austria and Finland have transposed a 2% minimum overcollateralization amount while for the remaining seven (ie France, Spain, Netherlands, Italy, Norway, Belgium and Portugal) require a 5% overcollateralization amount. It is interesting to see how in some jurisdictions the statutory overcollateralization is higher than what the rating agencies require to assign the rating to the covered bond.

LABELLING

Finally, when looking at how each Member State has transposed the labelling requirement (art.27 CBD) it is clear that each national regulator has focused on giving the ability to their issuers to issue European Covered Bonds (Premium) with European Covered Bonds being issued only if the issuances do not comply with the requirements of the CDB or the national frameworks. Of the 12 Member States analysed none seem to have transposed the ability to issue European Covered Bonds backed by assets such as auto loans or public undertakings. Finally, we have seen divergence amongst Member States on how grandfathered covered bonds should be labelled, there are some jurisdictions like Spain and Belgium where once the covered bond programmes have been updated to become CBD and CRR compliant, all covered bonds issued from the programme pre or post 8 July 2022 have been/can be labelled as European Covered Bond (Premium) while in most other jurisdictions only covered bonds issued post the update of the programme to comply with the new covered bond package can benefit from the European Covered Bond (Premium) label.

Issuer Country	OC Requirement		Liquidity Buffer Calculation	Extension Triggers
Denmark	2% nominal 2% nominal 2% nominal	CRR Compliant - Residential CRR Compliant - Commercial CRR Compliant - Ships	> Principal included at all times	> a refinancing failure trigger and an interest rate trigger
Germany	2% NPV + Nominal 2% 2% NPV + Nominal 2% 5% NPV + Nominal 5% 5% NPV + Nominal 5%	Public Sector Mortgage Ship Aircraft	> Principal included at all times	> Issuer bankruptcy/resolution
France	5% nominal 5% nominal	All types	> If the Issuer issues soft bullet covered bonds then the extended maturity date will be used to calculate the liquidity buffer	> Issuer bankruptcy/resolution > Lack of liquidity: breach of liquidity rules > Issuer failure to pay
Spain	5% nominal 5% nominal	Mortgage Public Sector	> For soft bullet covered bonds, principal included in covered bonds extend	> Issuer bankruptcy/resolution > Lack of liquidity; breach of liquidity rules > Other: The declaration of non-viabiility of the issuer in accordance with Art. 8 of Law 11/2015 of 18 June 2015 on the recovery and resolution of credit institutions and investment services firms The existence of serious disturbances affecting the national financial markets, where this has been assessed by teh Macroprudential Authority FInancial Stability Board (AMCESFI) by means of a public communication.
Sweden	2% nominal and NPV	All types	> If the Issuer issues soft bullet covered bonds then the extended maturity date will be used to calculate the liquidity buffer	> The maturity may be extended subject to such extension being permitted by the Swedish FSA as a result of it being deemed likely that the extension will prevent insolvency.
Netherlands	5% nominal	Taking CRR LTV cut-off limits into account	> Calculation of the net liquidity outflow shall be assumed that the principal amount of the covered bonds is to be repaid on the extended maturity date	> Issuer bankruptcy/resolution > Issuer failure to pay
Italy	5% nominal	Residential	> Principal included only if covered bonds extend	> Issuer event of default > The OBG Guarantor has insufficient moneys available under the Priority of Payments to pay the Guaranteed Amounts corresponding to the final Redemption amount in full, in respect of the relevant series of OBG
Norway	5% nominal 2% nominal	Mortgage or commercial real estate Public sector	> Calculation of the liquidity buffer requirement for covered bonds allowing for maturity extensions may be based on the extended maturity date	> Issuer bankruptcy/resolution > Other > The Issuer is likely to fail in the near future and there is no reasonable prospect that any alternative measures can prevent the issuer from failing.
Austria	2% nominal (or optional 2% PV)	All types	> Calculation of the liquidity buffer requirement for covered bonds allowing for maturity extensions may be based on the extended maturity date	> Issuer bankruptcy/resolution
Finland	2% market value 5% market value	If CRR 129 article 3a met If not met	> Calculation of the liquidity buffer requirement for covered bonds allowing for maturity extensions may be based on the extended maturity date	> Lack of liquidity; actual/potential breach of liquidity rules > Other: Issuer unable to obtain conventional long-term funding
Belgium	5% value of cover asset basis	On a value of Cover Asset basis	> If the Issuer issues soft bullet covered bonds then the extended maturity date will be used to calculate the liquidity buffer	> Issuer bankruptcy/resolution > Issuer failure to pay
Portugal	5% nominal 10% nominal 10% nominal	Mortgages and public sector Obrigações Cobertas Europeias (Premium) backed by commercial mortgages allowing maximum LTV of 70% Public Sector	> Principal included only if covered bonds extend	> Issuer failure to pay > Other: Withdrawal of the issuer's banking licence. CMVM can object to maturity extension

Source: https://compare.coveredbondlabel.com/frameworks
https://www.esma.europa.eu/sites/default/files/library/categories_of_covered_bonds_and_issuers_of_covered_bonds.pdf
https://www.cliffordchance.com/content/dam/cliffordchance/briefings/2023/04/new-framework-applicable-to-italian-covered-bonds-comparing-the-main-differences-and-similarities-with-other-european-jurisdictions.pdf

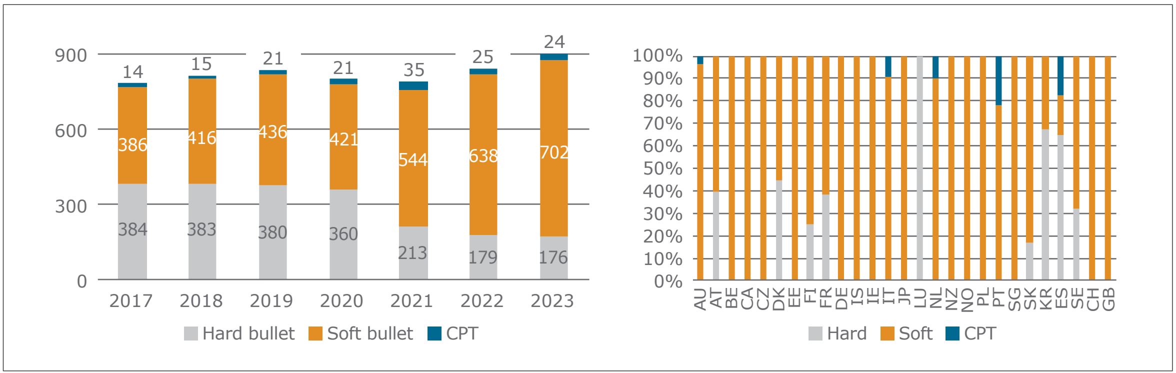
HOW THE CBD IS SHAPING THE MARKET

The sections that follow give an overview of the some of the changes introduced via the CBD and how they are shaping the covered bond market.

Soft bullet dominant structure

One of the key features of the new CBD was the inclusion of conditions for extendable maturity structures. This was likely due to the emergence of covered bonds with extendable maturities, either in soft bullet or conditional pass-through (CPT) format, over the past years. Indeed, already back in 2017, 49% of euro benchmark covered bonds in the iBoxx index had a soft bullet structure, while 1.8% had a CPT structure, leaving 49% of traditional hard bullet covered bonds. In June 2023, only 19% of hard bullet covered bonds remained in the iBoxx euro covered bond index, while 78% of the bonds in the index were soft bullets and 2.7% CPT covered bonds. So, the transposition of the CBD into national covered bond laws has resulted in a further rise in the share of covered bonds with extendable maturities, with the switch of German Pfandbriefe from hard to soft bullets already having a big impact (as their share in the index is almost 20%).

> FIGURE 1: OUTSTANDING AMOUNTS OF COVERED BONDS IN IBOXX EUR COVERED BOND INDEX BY MATURITY STRUCTURE OVER THE YEARS (LEFT, EUR BN) AND BY COUNTRY (JUNE INDEX, % SHARE)



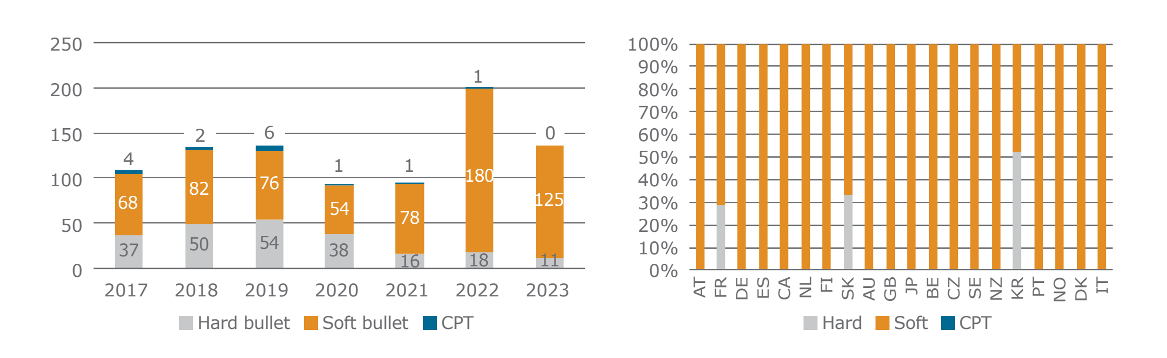
Source: Bloomberg, ABN AMRO, 2023 data is June index

A breakdown of outstanding covered bonds by maturity type and country shows that only Luxembourg has only hard bullet covered bonds outstanding (but only one bond as well), while in Spain and South Korea around 65% of outstanding covered bonds are still in hard bullet format. Austria, Denmark, and France are also jurisdictions where around 40-45% of outstanding euro benchmark covered bonds are hard bullets. But roughly half of the jurisdictions that are included in the index have only soft bullet covered bonds outstanding, while some have a combination of soft bullet and CPT covered bonds. Interesting in this respect are the Netherlands, where in 2013 the first CPT covered bond was issued. However, all the issuers that initially opted for this structure have now switched to soft bullet covered bonds. This will reduce the amount of outstanding CPT covered bonds over time. Moreover, some of the Dutch issuers have asked investor consent to change their CPT covered bond to soft bullets (NN Bank and Achmea Bank), having terminated their CPT covered bond programmes.

As said, the CBD has stimulated more and more countries to embrace the maturity extension structure when transposing the CBD into national law. As a result, soft bullet covered bonds will further enlarge their footprint, with CPT covered bonds slowly disappearing. This was clearly visible in the issuance data. Only looking at last year's issuance of euro benchmark covered bonds from issuers located in the euro area, 85% of the total volume of new supply were soft bullet covered bonds. Furthermore, these were also issued from a range of euro area countries. After 8 July 2022 (the date that the CBD became effective), the share of soft bullet covered bonds in total issuance rose to 92%, while that of hard bullet covered bonds dropped to just below 8% (was 15% in

January-June period). Moreover, the hard bullet covered bonds were only issued by French issuers that have been committed to hard bullet covered bonds.

> Figure 2: New issuances of covered bonds in iBoxx EUR covered bond index by maturity structure over the years (left, EUR bn) and by country (June index, % share)



Source: Bloomberg, ABN AMRO, 2023 data is June index

Taking into account euro benchmark issuance of all jurisdictions in 2022, 90.4% of the volume of new issuance of euro benchmark covered bonds were soft bullet covered bonds, 9.3% were hard bullets, and 0.3% were CPT covered bonds. This compares to shares of 62.6%, 33.9%, and 3.4% in 2017, respectively. This year (2023), the share of soft bullets rose further to 92%, while that of hard bullets was 8% (implying no CPT covered bond issuance so far in 2023). Only French, Slovakian, and Korean issuers came to the market with hard bullet covered bonds. This clearly illustrates the dominance of covered bonds with a maturity extension, and especially soft bullet covered bonds, which in fact have become (and will remain) the standard format for covered bonds.

Smooth transition to Premium Label

The transposition of the new CBD in national laws was a lengthy process. Regulators in some countries only released all details of the updated covered bond framework just ahead of the CBD becoming effective as of 8 July 2022, while in some other countries the details were published even months after the deadline passed. Still, the transition to the new regime has gone smoothly. Under the new regime, covered bonds that comply with the CBD as well as with the update Capital Requirements Regulation (CRR) Article 129 can be labelled 'European Covered Bond (Premium)', benefitting from favourable regulatory treatment (Generic Section, Chapter 2). The first Premium-labelled euro benchmark covered bond was issued on 18 July 2022 by German bank LBBW and the covered bond market has welcomed many more since then, with the first Portuguese and Italian Premium covered bonds arriving in April and June 2023. Almost all euro benchmark covered bonds that were issued after 8 July 2022 have the Premium label, while in some countries also covered bonds issued before 8 July 2022 have been labelled Premium following an update of the issuers' covered bond programmes. As such, a large portion of the index already consists of Premium-labelled covered bonds.

The transition has also gone unnoticed with regards to the pricing of covered bonds in the primary and secondary markets. Indeed, there was no material difference observable between new issue premiums and demand for Premium covered bonds and covered bonds issued before 8 July that benefitted from similar regulatory benefits (i.e., those that complied with the UCITS Directive 52(4) as well as the CRR). This underlines the strength of the asset class (also already before the CBD became effective) and the confidence investors have in the product. With the majority of covered bonds now being in extendable maturity format, it also shows that the vast majority of investors is comfortable with investing in covered bonds with maturity extension features.

CONCLUSION

In a political union of 27-countries where, depending on which, the history of covered bond ranges from just over a decade to more than 250 years, the idea of harmonising domestic legislations, market practices, and even conceptualisations of what a covered bond is, or ought to be, was often seen as an overly ambitious project. Quite the contrary ended up being the case.

The strategy designed and adopted – starting with the choice of a principle-based approach, followed by deep involvement of the industry, their market players and experts, whose voice the ECBC takes to the European authorities through its members and the analytical work of dedicated teams, a constant presence throughout the multi-year legislative process – showed as much commitment with the initial objectives as an impressive market sense and pragmatism.

Now that the initial objectives have come to fruition, with the CBD fully transposed into each and all of the EU member states and, not least, being chosen as blueprint for covered bond legislations elsewhere, one point became clear: a close working relationship between market players, authorities, and regulators in equal measure, proved to be a fundamental ingredient of the secret sauce flavouring constructive, supportive and effective European-wide capital market legislation.

1.9.1 An European Secured Note (ESN) manifesto for the sustainable financing of EU SMEs

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Foreword

This box highlights the steps undertaken by the ESN initiative and its current importance, not only to support a well-functioning CMU but also as a catalyst for the EU recovery and the renovation wave through the SME sector, and for the role that the covered bond community can play in this regard.

In the new environment, SMEs and smaller businesses will play a central role in ensuring strategic investments, resilience and de-carbonisation. SMEs, the backbone of the EU economy, will still need bank financing to run and innovate their business, at viable conditions. As regard banks, economic uncertainty and rising interest rates would need a long-term financial instrument capable of ensuring stable funding through the cycle and optimising asset liability management.

In this respect, ESN represent an opportunity to use covered bonds technique on the SME sector boosting ESG developments and fostering financial stability.

Background

> The European Secured Notes (**ESN**) project was initiated as the ECBC response to the Capital Markets Union (**CMU**) in 2015.

> The idea was to use the covered bond structure (dual recourse, public supervision) as a new tool to finance SMEs. According to the Covered Bond Directive (**CBD**), the European Commission is expected to publish a report on ESN by July 2024 and, if appropriate, a legislative proposal.

> The ECBC has been pro-active though its ESN Task Force in providing analysis and concrete and viable proposals to the EU regulators, benefiting from the knowledge of its members in the functioning of the covered bond product.

> In the **ESN Blueprint**[1] there are concrete proposals for a regulatory recognition, necessary for the success of the instrument.

1 https://hypo.org/app/uploads/sites/3/2017/05/ECBC-ESN-Blueprint-April-2021.pdf

> financial features: (i) ESN yield is expected to range between the yield of covered bonds and the one of senior unsecured debt; (ii) we expect shorter tenors, in line with the average maturity of the SME underlying assets.
> ESN could then represent an alternative for investors wanting a different combination of maturity and return on their investment

Where do we stand?

Few initial considerations. Corporate financing in the EU, especially for the SME segment, is still reliant on banking finance. The CMU initiative was enriched over time with a number of initiatives aimed at boosting capital markets from different angles[2]. However, despite the initiatives undertaken, the share of banking finance to the corporate sector has not decreased overall and remains very far from the US model, where capital markets account for three quarters of corporate financing, allowing to share a larger part of the corporate risk among different stakeholders.

Covered Bonds have continued to play a pivotal role in these last years and their function for the overall financial stability has been confirmed: now they are developing in almost all EU jurisdictions as a harmonized tool thanks to the CBD. Furthermore, green issuances are building-up, thus contributing to the sustainable transition of the mortgage sector and the gradual exit from the CBPP of the ECB is reinstating the role of the market and of the covered bonds investors.

After the huge effort recently made by the European Union in supporting its economies, growth seems to resist in the current environment and EU is proving its resilience. However, uncertainty is looming again on the world economy, including vulnerability to energy prices, which could undermine long-term viability of EU companies. In a rising interest rate and inflationary context, where overall lending is decreasing, the introduction of ESN would contribute countering the increase in the funding cost for banks and therefore ultimately benefit businesses and SMEs.

A regulatory recognition of ESN, through well-defined requirements ensuring soundness and quality of the eligible assets, would therefore add stability and resilience, channeling cheaper funds through banks to the real economy, including innovative companies. They would also contribute to harmonization of the ESG disclosure on SMEs. In a context where EU funds have already been deployed for the post pandemic recovery, no additional public resources would be requested, and the whole roll-out of such instrument would totally be on the shoulders of lenders.

What could be done to improve SME financing

Interaction with other funding sources. In addition to covered bonds, the introduction of ESN could be another enabler for the development of EU capital markets, especially in countries where banks' lending may be more oriented toward businesses rather than mortgages.

A direct key instrument to finance SMEs through capital markets is securitisation, which through the tranching of the notes, allocates the risk underlying the asset pool to different investors with specific risk-reward appetite and ensures at the same time funding and capital relief for originators. Despite the positive innovations brought by the Securitisation Regulation, the market never actually recovered after the GFC and the share of SME funding through securitisation remains, alas, not significant[3].

2 e.g. through public access to companies' data, easing listing rules for smaller companies and for long term investment funds, which may allocate resources to sound and innovative SMEs.

3 The only segment which, through capital relief, concretely caters for new lending to corporate and SMEs in recent years is the so-called on-balance sheet securitisation.

The creation of ESN as dual recourse instrument for SME financing is therefore not in contradiction with SME asset-backed securities and may be used by originators together with securitisation, depending on their objectives and market timeframe.

In the overall CMU initiative, which is expected to be re-assessed by regulators, complementarity is key: improving funding conditions for corporates and SMEs is not to be seen as detrimental to the needed development of EU financial markets. Even more so, after the gradual phase-out of the TLTRO programmes of the ECB, where banks could finance their SME portfolios at excellent conditions. ESN would also be compatible with the broad range of guarantees, direct investments and financing currently provided by the European Investment Bank group to support specific economic sectors, thus integrating the private financing of SMEs.

In order for banks to set-up their programmes, the ESN features should ideally be set timely by the regulators. To this respect, the ESN Task Force has already provided an analysis on the aspects where a possible ESN legislation should deviate from the CBD and for which aspects the ESN should instead follow the existing covered bonds provisions.

<u>ESN are also interesting from an ESG angle</u>. The milestones set by EU institutions in terms of carbon neutrality are ambitious. Many important initiatives have been launched concerning the financial sector and other specific sectors and directly impact the CB stakeholders (e.g. the Energy Performance of Buildings Directive, **EPBD**[4]). The role of the private sector here is key, as resources cannot be provided by the public sector alone.

Large corporations and listed companies are now subject to increasing requirements in terms of taxonomy and ESG disclosure. Investors will be permitted to access companies' data through a single entry point, and we may expect that the increased accessibility and availability of this information would affect their investing decisions[5].

ESG data availability and disclosure is even more critical for micro enterprises and several initiatives, also from the private sector and academia, are in process toward the collection and scoring of ESG data on small businesses. Rating Agencies, who are also involved in providing comparable criteria on ESG ratings, have already published their methodology on ESN. Where data lacks, especially in the stock of existing assets, some proxies may be used, helping the transitional phase[6]. As new lending is concerned, authorities encourage lenders to collect ESG data at origination, but this also will take time.

ESN, again, could contribute to a process towards making ESG data of small businesses homogeneous and available. Also building on the success of the covered bonds Harmonized Transparency Template (HTT), which has proven its quality and has been recognized by regulators and is gradually introducing ESG features on mortgages in the cover pool. The Energy Efficient Mortgage Initiative[7] has set the specific **Harmonised Disclosure Template**, which will enhance the overall ESG disclosure of cover pools. SME disclosure differs from mortgage disclosure in terms of homogeneity of their underlying: the ESN Task Force will set out possible paths to conceive a harmonized template fit for the SMEs and for the disclosure of their ESG features, also building on the general progress in this context.

4 Buildings energy efficiency, enhanced by the EPBD requirements are also expected to trigger the intervention of companies (including SMEs) to carry out such renovations, therefore increasing the systemic need of new finance for the sustainable transition.

5 Legislation provides for phase-in periods to enlarge the scope of application to larger or listed SMEs. See for example the Corporate Sustainability Reporting Directive and the European Single Asset Point Regulation.

6 This holds true also for mortgages, where energy certificates often represent a limited portion of the entire mortgage stock

7 Since 2015 the Energy Efficient Mortgages Initiative (EEMI), through renovation programmes needed to improve the energy performance of the EU's building stock, has been the catalyst for the growth of a new, integrated, multi-stakeholder energy efficient mortgage Ecosystem. https://energyefficientmortgages.eu/ – Please, see also article 1.5 of this Fact Book.

Are ESN still relevant in the current context?

Wrapping up, we argue that ESN – which would foster both innovation and financial resilience – seem to be a great opportunity and a tool ready-to-use in the medium term to face the major constraints in front of us, macroeconomic uncertainties, the concrete need to keep on financing the real economy and the irreversible transition toward the sustainability targets of the EU.

We believe pragmatism should prevail and improving funding conditions for banks – also through an instrument such as ESN – is not in contradiction with the need to develop capital markets. In an uncertain macroeconomic context, we strongly believe that the private sector, using all tool available, has its role to play to help the efforts deployed by EU institutions towards a net zero emissions by 2050. Through a medium term process the banking sector will gradually provide more reliable ESG data on its assets, making data sounder and comparable and reducing the risk of greenwashing. Standardised disclosure is a must and contributes to the stabilization of a sound investor base.

The covered bond community stands by EU regulators and is ready to bring to the market ESN as a new regulated dual recourse instrument to finance SMEs, strategically important for the positioning and competitiveness of the EU.