1.6 THE TRANSPOSITION OF THE COVERED BOND DIRECTIVE: TAKING STOCK

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INTRODUCTION

Within Europe's Capital Markets Union strategy, the aim of strengthening the covered bond market and ultimately provide financial stability, led the European Banking Authority (EBA), nine years ago, to express the need to harmonise covered bond frameworks in the European Union (EU). Five years later, in 2019, the principle-based Covered Bond Directive (CBD) was approved.

Art. 31 of the CBD commanded the Commission, in close cooperation with EBA, to submit to the European Parliament and the Council a report elaborating on the level of investor protection and developments on covered bond issuance under the CBD.

To that end, in July 2023, the Commission published a Call for Advice (CfA) seeking "input and technical assistance from EBA to conduct the reviews referred to in Art. 31 of the CBD". The scope of EBA´s CfA includes an assessment of the merits (as well advice on the design) of introducing a third country covered bond regime (see article 1.10), as well as of the possibility of introducing a dual-recourse instrument named European Secured Note ("ESN") (see Box in page 1.10.1) – themes which are dissected in the indicated articles.

Additionally, the Commission's CfA tasks the EBA's with an examination of market trends in the use of covered bonds with extendable maturity structures, as well as with assessing the risks and benefits arising from the covered bonds with extendable maturities. Within the scope of assessing the "performance of the covered bond framework", it also asks for an assessment of the implementation of CBD's coverage and liquidity requirements in contributing to mitigating liquidity risks associated with covered bonds, as well as the extent to which EU credit institutions have made use of the "European covered bond" label in their programmes. These are all themes this article will address in the following sections.

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 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.

As part of the CfA, EBA has been mandated to assess if extension features are sufficiently disclosed to allow investors to assess the risk and benefits of extendable covered bonds. Furthermore, EBA are considering if more harmonisation is required when it comes to identifying the extension triggers.

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 3 countries being Denmark, Germany and Spain include covered bond principal payments as outflows at all times in the liquidity buffer calculation while the other 9 all allow issuers to calculate the liquidity buffer using the extended maturity date in case of soft bullet or conditional pass-through covered bonds.

The liquidity buffer calculation is another feature that the EBA is scrutinizing as part of its mandate from the EC. In particular, EBA is assessing how each EEA member state has exercised its discretion when implementing Art.16 CBD with regards to the inclusion on principal 180 days before the expected or the extended maturity date. As mentioned above it is clear that most of the EEA countries have opted to use the extended maturity date in the calculation of the buffer, however if this is the case EBA is querying if other liquidity mitigants should be in place.

MINIMUM OVERCOLLATERALIZATION

Another requirement that was left to transpose at the national regulators' discretion was the minimum over-collateralization 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, the final maturity date is used to calculate the liquidity buffer	> 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 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 2024, only 16% of hard bullet covered bonds remained in the iBoxx euro covered bond index, while 82% of the bonds in the index were soft bullets and 1.7% 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, now that an increasing number of countries have included the possibility for issuers to issue covered bonds with extendable maturities. German Pfandbriefe, which account for 20% of the total index, moved, for instance, from hard to soft bullets in 2021. Overall, the difference between the share of hard and soft bullet covered bonds in the total index widened from 0% at the end of 2017 to 66% in June 2024.

> Figure 1: Outstanding amounts of covered bonds in iBoxx EUR covered bond index by maturity structure over the years (left, % share in total) and by country (June index, % share)

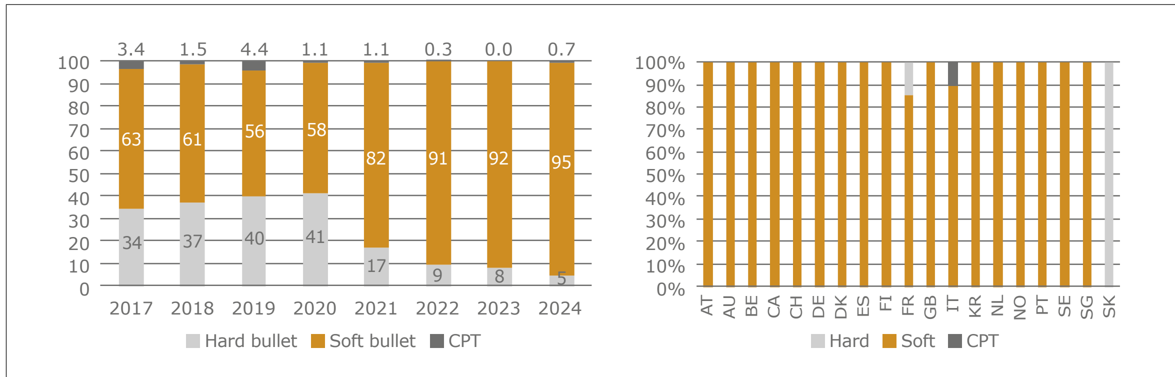
Source: Bloomberg, ABN AMRO, 2024 data is June index

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 slightly more than 50% of outstanding covered bonds are still in hard bullet format. Austria and France are also jurisdictions where around one third of outstanding euro benchmark covered bonds are hard bullets. But more than half of the jurisdictions (57%) 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 has halved the share of outstanding Dutch CPT covered bonds in total Dutch covered bonds in the index to 6% between 2017 and 2024 and this share will move to zero over time.

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. In 2020, 58% of the total volume of new supply were soft bullet covered bonds, while still 41% had a hard bullet structure.

Last year, so when the new CBD was fully effective (already from 8 July 2022), the share of soft bullet covered bonds in total issuance rose to 92%, with 8% having a hard bullet structure. This year, the share of soft bullet issuance increased further to 95%, clearly indicating that it has become the dominant structure in the covered bond market. Moreover, hard bullet covered bonds will remain to be issued by mainly French issuers that have been committed to hard bullet structure.

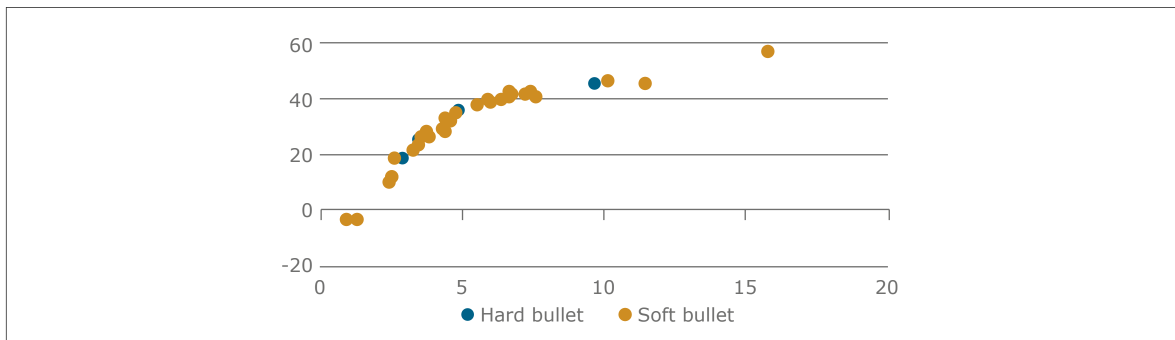
> Figure 2: New Issuances of covered bonds in iBoxx EUR covered bond index by maturity structure over the years (left, % in total) and by country (in H1 2024, % share)



Source: Bloomberg, ABN AMRO

The increasing dominance of soft bullet covered bonds has gone hand in hand with investor confidence in investing in covered bonds with maturity extension features. A couple of issuers have both hard and soft bullet covered bonds in the iBoxx index, which allows for a good comparison of any price differences between both structures. The chart below, taken from a French issuer, shows that there is no price difference between hard and soft bullet covered bonds, underlining that investors do not see any difference in the risks attached to these bonds. A similar picture arises when looking at other issuers. As such, it seems that soft bullet covered bonds will remain the standard of the covered bond market, as both issuers and investors appreciate the structure.

> Figure 3: Pricing of hard and soft bullet covered bonds of one French issuer, X-axis is years-to-maturity, Y-axis: Z-spreads in bp



Source: Bloomberg, ABN AMRO

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) Art. 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, and this will only grow over time.

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.

The initial objectives have come to fruition: the CBD is fully transposed into each, and all the EEA member states and, not least, being chosen as blueprint for covered bond legislations elsewhere. Next is for the European Commission, in consultation with EBA, to adopt and submit a report to the European Parliament and the Council, essentially conveying how successful this whole exercise has been. With all this, one point has become 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's legislation.