

2.1 OVERVIEW OF COVERED BONDS

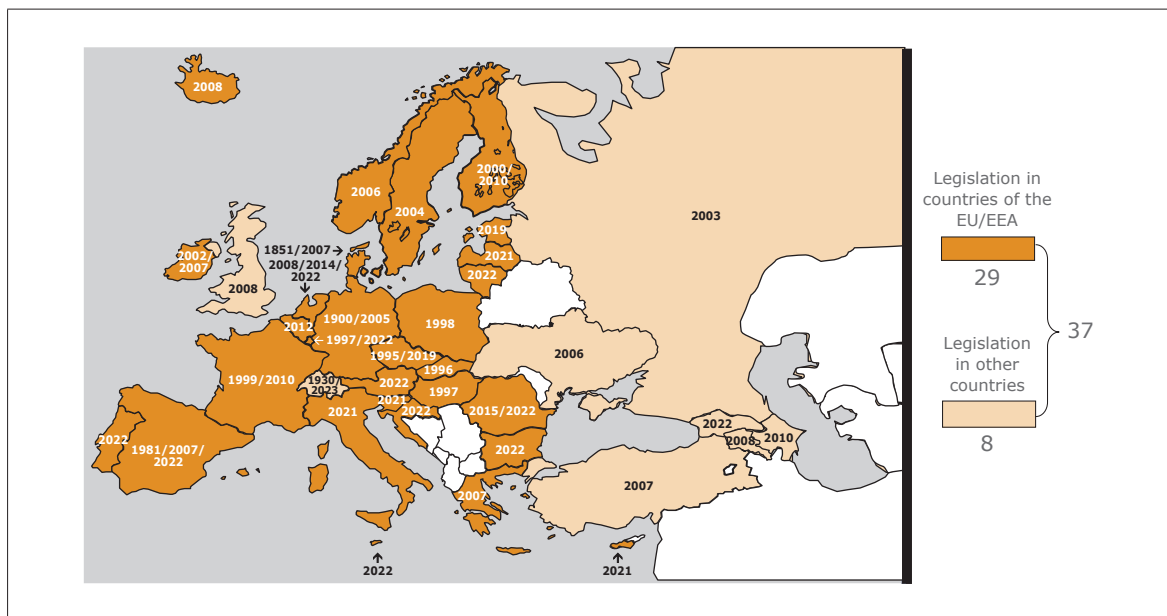
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I. INTRODUCTION

The covered bond is a pan-European product with a long-standing history. Decisive milestones in its development were laid in Prussia (1770), Denmark (1797), Poland (1825) and France (1852). Traditional issuers ranged from public law “Landschaften” to private mortgage banks. Initially, the instrument’s aim was to finance agriculture, but it later concentrated more on housing and commercial real estate.

Over the past 25 years, the covered bond market has developed into the most important segment of privately issued bonds on Europe’s capital markets, with volume outstanding as of end-2023 of over EUR 3 trillion. Today, there are active covered bond markets in about 30 different European countries (please refer to the covered bond statistics section in chapter 5 for more information). The covered bond market has also expanded beyond European borders to become a global product: countries such as Australia, Brazil, Canada, Croatia, Georgia, New Zealand, Singapore, South Korea, have established covered bond legislation, and others are looking to establish CB frameworks.

> FIGURE 1: COVERED BOND LEGISLATION IN EUROPE (AS OF MAY 2024)



in volatile times. The high importance of covered bonds from the financial system is demonstrated by the regulatory privileges these instruments enjoy in various areas of EU financial market regulation. The new EU legislation on covered bonds in Europe effective from July 2022 further reinforced the conditions for granting preferential capital treatment to covered bonds by adding further requirements. At national level, in addition to the introduction of new covered bond legislations, there have been continuous evolutions/amendments to existing legislations, underlying the commitment of issuers, investors and regulators to take on board the best practice standards and further reinforce and enhance the quality of the asset class.

Covered bonds as a long-term funding tool for the real-economy: the example of housing finance

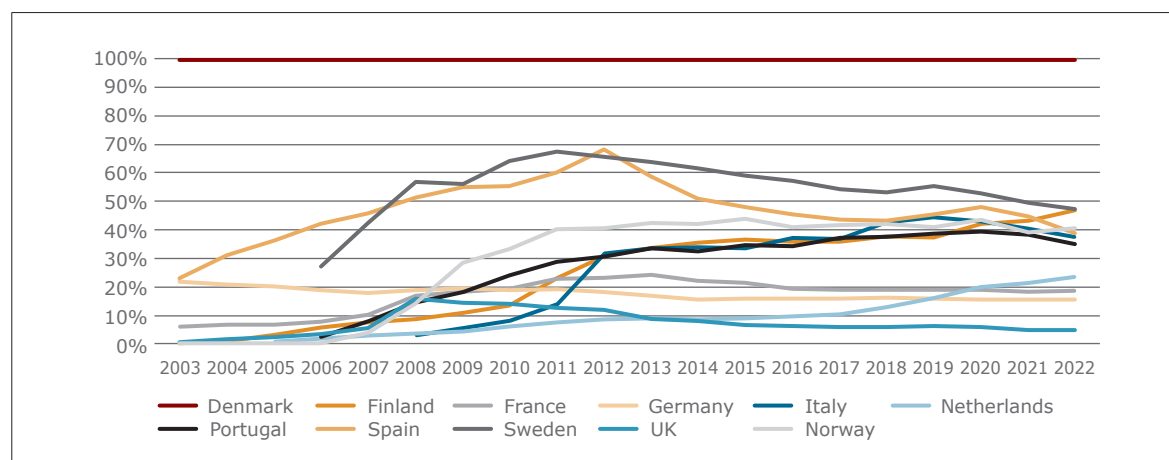
Covered bonds are an effective tool to channel long-term financing for high quality assets at reasonable cost. They improve bank's ability to borrow and lend at long-term horizons and, hence, represent a stable source of funding for key banking functions such as housing loans and public infrastructure. In this regard, we believe that covered bonds represent a key funding tool for the (European) banking industry.

The use of covered bonds as a funding tool depends largely on the size of the domestic mortgage market, and the availability of alternative funding tools for banks (and their costs). The figure below shows that in most countries mortgage backed covered bonds account for at least 30% of outstanding mortgage loans. Most of the countries have now reached stable relative size of the covered bond market after a phase of strong growth in 2007/2008, and a more moderate growth subsequently.

Prerequisites of a covered bond system are:

- > Specific legislation on Covered Bonds,
- > Independent and specific (government) oversight,
- > Specific regulatory support,
- > Equal tax treatment with government bonds,
- > Specific protection of covered assets.¹

> FIGURE 2: MORTGAGE BACKED COVERED BONDS AS % OF RESIDENTIAL MORTGAGE LOANS



Source: EMF-ECBC

¹ In Footnote: Including – among others – efficient systems for (1) registration of real estate and pledges over real estate, (2) foreclosure and (3) bankruptcy. With these questions in detail deals the Round Table "Security Rights over Immoveable Property (www.vdpmortgage.com)".

Benefits of covered bonds

From an issuer's perspective, covered bonds enable banks to enhance their funding profile and manage their liquidity. Benefits provided by covered bonds include:

- > Providing banks a diversification of their funding mix, allowing asset liability management (ALM) teams to better adapt their funding strategy to market conditions;
- > Extending the maturity profile of the liabilities, allowing banks to better match their long-term asset portfolios;
- > Enabling issuers to increase diversification of the investor base, both in terms of geography and investor type, in particular to the more conservative investors. This phenomenon can also be evidenced by issuers turning to the issuance of green covered bonds, as they seek to broaden their investor base;
- > Transforming less liquid mortgage loans into covered bonds which are eligible as collateral for central bank liquidity (including own use); and
- > Servicing the industry as one of the most reliable funding tools, even in times of turmoil.

From an investor's perspective, the major strengths and regulatory advantages of covered bonds can be summarized as follows:

- > Dual recourse to the issuer and a cover pool of high-quality assets (and therefore higher recovery in case of liquidation of the CB issuer);
- > Higher rating and higher rating stability than unsecured debt;
- > Lower risk-weighting for EEA covered bonds bought by EEA banks under the EU's CRR;²
- > Eligible as liquid assets under the EU LCR regulation;³
- > Exemption from bail-in under EU's BRRD;⁴
- > Privileged treatment of covered bonds under the EU large exposure rules;⁵
- > Favourable treatment under Solvency II;⁶
- > Higher investment share for funds in UCITS Directive;⁷
- > Favourable repo treatment at the European Central Bank (ECB)⁸ and other central banks.

² Art. 129 Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012; Official Journal of the European Union L 176/1 – 337 dated 27 June 2013.

³ Art. 10 (1)(f), (2); art. 11 (1)(c)(d); art. 12 (1)(e); art. 15 (2)(b)(c)(f); art. 17 (1)(b); art. 28 (3)(a)(b) Commission Delegated Regulation (EU) 2015/61 of 10 October 2014 to supplement Regulation (EU) No 575/2013 of the European Parliament and the Council with regard to liquidity coverage requirement for Credit Institutions; Official Journal of the European Union L 11, 1 – 36 dated 17 January 2015.

⁴ Art. 44 (2) subsec 1(b); subsec 2; art. 76 (2)(c); art. 79 Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012, of the European Parliament and of the Council; Official Journal of the European Union L 173, 190 – 348 dated 12 June 2014.

⁵ Art. 387; 400 (2)(a) CRR (and Basel Committee on Banking Supervision (BCBS) rules (Rules 2023, 30.37 – 30.40)).

⁶ Art. 180; 187 Commission Delegated Regulation (EU) 2015/35 of 10 October 2014 supplementing Directive 2009/138/EC of the European Parliament and of the Council on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II); Official Journal of the European Union L 12/1 – 797 dated 17 January 2015.

⁷ Art. 52 (4) Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS); Official Journal of the European Union L 302/32 – 96 dated 17 November 2009.

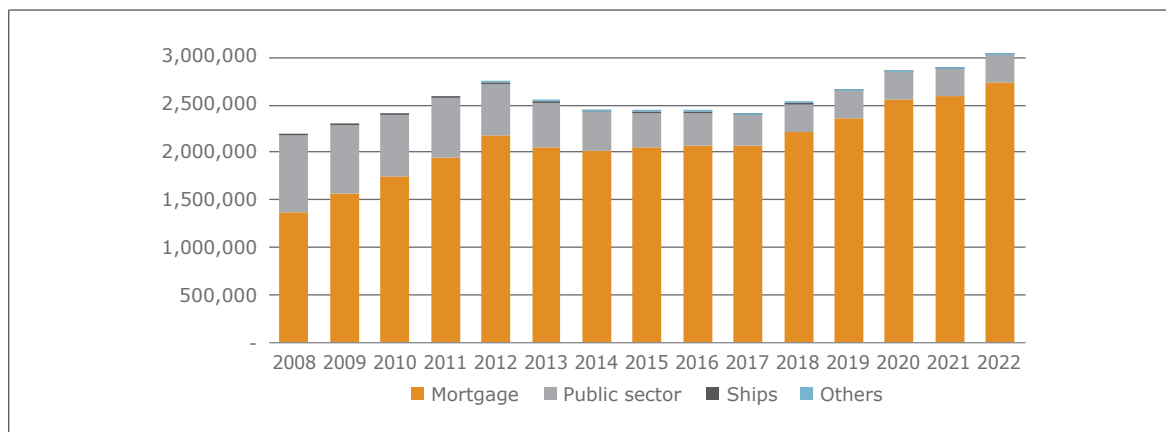
⁸ From 29 June 2023, all covered bonds and multi-Cédulas will be assigned to haircut category II.

Resilient bank funding instrument

Covered bonds are the most reliable funding source, as they make banks less susceptible to adverse market conditions. They often offer issuers better wholesale capital market access, lower transaction execution risk, and decrease the reliance on senior unsecured funding and interbank markets. This is especially true during times of crises. During the European sovereign crisis of 2011-2012, covered bond issuers of some jurisdictions had, for instance, cheaper access to wholesale funding markets via covered bonds than their respective distressed sovereigns.

The development of covered bonds has also been shaped by regulation. The 2014 EU Liquidity Coverage Directive established covered bonds as eligible for Level 1 and Level 2A High Quality Liquid Assets (HQLA). As a result, bank treasuries have become regular buyers of covered bonds to include in their liquidity portfolios.

> FIGURE 3: TOTAL OUTSTANDING COVERED BONDS BY UNDERLYING ASSETS, 2008 TO 2022



Source: EMF-ECBC – Covered bonds outstanding at the end of 2022.

II. EU HARMONISATION OF COVERED BONDS

On 7 January 2020, the legislative package for the EU-wide harmonisation of covered bond (CB) frameworks entered into force, with the new measures having become effective from 8 July 2022.

The harmonisation package consists of a Covered Bond Directive (CBD) and an amendment of Article 129 of the CRR, which distinguishes the core group of traditional secured bonds issued by a credit institution more clearly from other kinds of covered bonds. The CBD regulates the requirements for covered bonds, which before were only laid down in a rudimentary fashion in Article 52(4) of the UCITS Directive; this provision has been accordingly amended and now refers to the CBD. Others, like the Bank Recovery and Resolution Directive (art. 2 (1)(96) BRRD) still refers to art. 52(4) UCITS Directive, which itself refers to the CBD. Given that the CBD has become the new single reference point for regulation related to covered bonds, various other provisions on covered bonds in other directives that refer to Article 52(4) of the UCITS Directive are thus also indirectly amended.

1. Principle-based harmonisation

The regulatory discussion on the creation of the CB harmonisation package was characterised by the “principle-based harmonisation” aimed at by the EU regulatory framework. This means that the EU provisions lay down the minimum requirements for secured bonds issued by credit institutions and, in a number of ways, leave room for particularities and detailed regulations at the national level; this has also been the (almost) unanimous

petition of CB issuers and other market participants. This is of fundamental importance both for understanding the regulatory package and for interpreting the individual provisions.

While the CBD builds on the essential traditional quality features of covered bonds, it leaves national legislators a wide margin of leeway in shaping their national CB laws. This is also illustrated by the fact that the CBD contains both mandatory and optional provisions. Some mandatory provisions also contain optional elements, and vice-versa.

2. Covered Bond – Directive

The recitals of both parts of the CB harmonisation package are worth reading, as they explain the aim of the harmonisation project and locate the new rules within the existing set of rules for covered bonds. The definitions listed in Article 3 of the CBD are also important for understanding individual provisions. The CBD consists of the following Titles:

- I. Subject matter, scope and definitions (Articles 1-3)
- II. Structural features of covered bonds (Articles 4-17)
- III. Covered bond public supervision (Articles 18-26)
- IV. Labelling (Articles 27)
- V. Amendments to other Directives (Articles 28-29)
- VI. Final provisions (Articles 30-34)

2.1 Dual recourse

Article 4 of the CBD describes the most important element of covered bonds, dual recourse. Although this term has been in use for a long time, there is often confusion as to what its two components should be. In fact, there are three components, as Article 4(1) of the CBD clearly illustrates in listing components a) – c):

- a) a claim against the credit institution (the CB issuer); this is the most important difference to securitisations (such as asset-backed securities and mortgage-backed securities) where the investor has a claim against an SPV as a non-bank;
- b) in the case of the insolvency of the CB issuer, a claim against the cover pool; and
- c) if the cover pool is insufficient, a claim against the insolvency estate of the CB issuer. If this third claim is regarded simply as a consequence of a), then “dual recourse” is the correct term, otherwise “triple recourse” would be more precise.

2.2 Bankruptcy remoteness of covered bonds

Article 5 of the CBD makes only brief mention of the fact that payment obligations attached to covered bonds are not subject to automatic acceleration upon the insolvency or resolution of the CB issuer.

This ensures that investors will receive their capital and interest payments at the time specified in the terms and conditions of the issuance, even if the CB issuer becomes insolvent. This “timely payment” is a key requirement in investors accepting low interest rates and in rating agencies granting covered bonds high ratings.

As simple as this sounds, difficulties arise when determining the time specified in the terms and conditions of the issuance. The “hard bullet” versions of covered bonds have a fixed maturity. However, most legislators allow this date to be extended under certain conditions. Many credit institutions use this for their CB issuances, which are then called “soft bullet” covered bonds or conditional pass-through (cpt) covered bonds. Article 17 of the CBD addresses this issue. For the extension of maturities of CB, please refer to pt. 2.9 below.

2.3 Eligible cover assets

In 2013, Article 129 of the CRR established the first uniform, EU-wide, and directly binding provision⁹ on which cover assets could be used to back a covered bond in order to achieve a favourable risk weighting. These requirements continue to apply.

- a) Article 6 of the CBD goes beyond the framework of Article 129 of the CRR and allows for additional cover assets. If such cover assets going beyond Art. 129 CRR are included in a cover pool, the covered bonds issued on this basis would lose their preferential treatment in accordance with Article 129 of the CRR, but can make use of the other special provisions directly linked to the CBD or other EU directives that refer to the CBD.

Furthermore, according to Article 27 of the CBD, a covered bond whose cover assets meet the requirements of Article 129 of the CRR may be labelled as a "European Covered Bond (Premium)". However, the term "Premium" may not be used for covered bonds that go beyond this group of cover assets. In the meantime, the term "Directive-only covered bond" is sometimes used for these bonds in order to simplify matters and to distinguish them from "CRR Covered Bonds".

- b) Article 6(1) of the CBD provides for four categories of eligible cover assets:

(1) Assets that are eligible pursuant to Article 129 of the CRR:¹⁰ These are mainly traditional assets, especially claims related to property financing, public financing, and ship financing. In this context, the following LTV ratios¹¹ apply to property and ship assets: residential immovable property mortgages 80%; commercial immovable property mortgages 60%;¹² and maritime liens on ships 60%.

(2) High-quality cover assets:¹³ exact criteria for the high quality of cover assets are not provided. Rather, it lists requirements that a cover asset has to fulfil by consisting of a claim for payment¹⁴ and a collateral asset.

These cover assets can also be property and ship financing that exceed the LTV ratios provided in Article 129 of the CRR, while collateral assets can also be provided as "physical collateral assets"¹⁵ or as "assets in the form of exposures".¹⁶

In the case of a mortgage loan, the collateral asset would be a lien encumbering a property (and thus a physical collateral asset). These physical collateral assets can be both movable and immovable assets. They require generally accepted valuation standards that are appropriate for the physical collateral asset concerned.

In addition, these physical collateral assets require the existence of "a public register that records ownership of and claims on those physical collateral assets."¹⁷ This requirement was one of the main points of contention in the provision, as there are no registers for many assets. As such, the following text was added: "Member

⁹ Requirements for cover assets for covered bonds were included for the first time in point 68 of Part I of Annex VI of Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions. This directive together with Directive 2006/49/EC of the European Parliament and of the Council of 14 June 2006 on the capital adequacy of investment firms and credit institutions were usually collectively referred to as the "CRD I Package". For more details on the CRD rules for covered bonds, see Engelhard, Covered Bonds and the EU Capital Requirements Directive, ECBC, European Covered Bond Fact Book, 1st Edition, 2006, p. 179 (pp. 180 et seq.).

¹⁰ Point (a) of Article 6(1) of the CBD.

¹¹ Loan to Value ratio. Article 129 of the CRR leaves it open as to whether national CB legislators define these LTV limits in absolute or relative terms (i.e., whether exceeding the loan amount leads to the result that the entire loan may not be used for cover, or whether the virtual division of the loan into a part for cover purposes and part outside of cover is permitted). The national CB laws differ considerably in this respect.

¹² This can be exceeded up to a maximum level of 70% if the total assets pledged as collateral for the covered bonds exceed the nominal amount of CB outstanding by at least 10%.

¹³ Point (b) of Article 6(1) of the CBD in conjunction with Article 6(2) and Article 6(3) of the CBD.

¹⁴ In the case of a mortgage loan, eligible claims for payment would be, for example, claims for payment of interest and principal.

¹⁵ Point (a) of Article 6(3) of the CBD.

¹⁶ Point (b) of Article 6(3) of the CBD.

¹⁷ Point (a) of Article 6(3) of the CBD.

States may provide for an alternative form of certification of the ownership of and claims on that physical collateral asset, insofar as that form of certification provides protection that is comparable to the protection provided by a public register in the sense that it allows interested third parties, in accordance with the law of the Member State concerned, to access information in relation to the identification of the encumbered physical collateral asset, the attribution of ownership, the documentation and attribution of encumbrances and the enforceability of security interests.”¹⁸ The EU legislator has thus opted for a broad recognition of national covered bond regulations and national certification and recognition schemes.

(3) Public undertakings:¹⁹ these include claims on loans to or guarantees by public undertakings within the meaning of Article 2 of the Transparency Directive.²⁰

The reference to this legal definition of public undertakings makes the scope of this category very broad.²¹ With its goal of classifying as many companies as possible as “public” (thus making them subject to transparency requirements), the EU Transparency Directive does not aim to define a group of high quality public borrowers or guarantors. Its application was a political compromise to settle the dispute about the scope of counterparties eligible for cover.

Further requirements are set out in Article 6(4) of the CBD. These contain several terms that are subject to interpretation, such as “provide essential public services” and “subject to prudential supervision”.

(4) Claims against credit institutions and insurance undertakings: On the one hand, recital 16 of the CBD makes it clear that credit institutions and insurance undertakings should not be considered public undertakings. In consequence, claims against them cannot be eligible for cover in accordance with point (c) of Article 6(1) of the CBD.

On the other hand, however, they fulfil the requirements for public supervision in accordance with point (b) of Article 6(3) of the CBD. This means that any claim for payment, for whatever legal reason, to cover European covered bonds is eligible if it is guaranteed by a credit institution or insurance undertaking.

In discussions, the European Commission stressed that the aim of the negotiations was to allow payment claims against credit institutions and insurance undertakings for European Covered Bonds (without Premium) to be accepted as eligible for unlimited covered (i.e., not only payment claims guaranteed by them). The collateral asset required by point (b) of Article 6(3) of the CBD is in these cases the “ongoing public supervision of the counterparty’s operational soundness and financial solvability” of the credit institution or insurance undertaking. Although the wording of Article 6 of the CBD is ambiguous, clarification is made in recital 16. Its mention of claims against credit institutions and insurance undertakings not only relates to guarantees, but directly to these claims.

In order to make this even clearer, on 12 September 2019, the EU expert group for the alignment of the various translations decided to change the order of the wording of recital 16 so that the statement that claims against credit institutions and insurance undertakings should be eligible for cover is presented in such a neutral manner that their direct eligibility for cover becomes even clearer. This change has been incorporated in a corrigendum, thus adopted and published with the CBD.

¹⁸ Last sentence of Article 6(3) of the CBD.

¹⁹ Point (c) of Article 6(1) and Article 6(4) of the CBD.

²⁰ Recital 16 of the CBD. Commission Directive 2006/111/EC of 16 November 2006 on the transparency of financial relations between Member States and public undertakings as well as on financial transparency within certain undertakings, Official Journal of the European Union of 17 November 2006, L 318/17.

²¹ In accordance with the legal definition in Article 2 of the EU Transparency Directive 2006/111/EC, a public undertaking means “any undertaking over which the public authorities may exercise directly or indirectly a dominant influence by virtue of their ownership of it, their financial participation therein, or the rules which govern it. A dominant influence on the part of the public authorities shall be presumed when these authorities, directly or indirectly in relation to an undertaking: (i) hold the major part of the undertaking’s subscribed capital; or (ii) control the majority of the votes attaching to shares issued by the undertakings; or (iii) can appoint more than half of the members of the undertaking’s administrative, managerial or supervisory body;....”

- c) Given the multitude of conceivable cover assets, Article 10 of the CBD aims to make covered bonds more or less uniform in order to ensure homogeneity in the national transposition by the EU Member States, without however defining how this is to be interpreted. Article 10 of the CBD²² leaves it to national legislators to decide how to regulate homogeneity. The more cover assets a national CB law permits, the more important it becomes to distinguish between them.
- d) The complicated topic of allowing derivative contracts in the cover pool is regulated separately in Article 11 of the CBD.

2.4 Segregation of cover assets

Article 12 of the CBD prescribes the segregation of cover assets but does not regulate it. It is thus left to Member States or, at their discretion, even to the issuers to ensure segregation.

- a) The legal structures of covered bonds cannot be harmonised

The basic legal structures of covered bonds vary widely and have developed over many years (in some cases centuries). In order to make it easier to compare and contrast these diverse forms, they are usually categorised in five different CB models based on the issuer: specialised funding institutions (vehicles), traditional specialized credit institutions, universal credit institutions, SPV models, and pooling models.

The fundamental differences are particularly evident in the rules governing the link between covered bonds and their cover assets, which are crucial for the segregation of both parts (of critical importance in the event of insolvency of a CB issuer) from the remaining assets of a CB issuer. The legal structure interacts with the degree of specialisation of CB issuers and their ability to integrate into banking groups, so any change in this legal structure would also affect the group structure.

Right from the start of the harmonisation work, the European Banking Authority (EBA) and the European Commission realised that the harmonisation of these fundamental features would not be feasible. It would have been necessary to intervene profoundly in the existing structures of active CB issuers and in well-functioning CB markets without being able to estimate the consequences and effort involved even approximately, and nobody wanted to examine the accounting and tax consequences of a model change in detail.

As such, Article 12(1) of the CBD only provides the following:

- > All cover assets have to be identifiable.²³ This can be done through entry in a cover register, as stipulated in most CB laws in EU Member States. This can also be achieved by establishing a separate legal entity for the cover pool²⁴ or even for the CB issuers,²⁵ so that the cover pool and total assets of this fully specialised company are basically identical; a cover register to decide on the distribution between the cover pool and the insolvency assets in the event of CB issuer insolvency is thus not necessary.
- > The respective CB law has to provide for segregation of assets.²⁶
- > The cover assets have to be protected from any third-party claims.²⁷

Limiting the provisions to these basic statements means that principle-based harmonisation also applies here, and the design is left to the national CB legislators.

²² Recital 18 of the CBD is also clear in this respect.

²³ Point (a) of Article 12(1) of the CBD.

²⁴ This is the case with the CB SPV models in Italy, the Netherlands, and the United Kingdom; here, the SPV is not a credit institution, but guarantees the covered bonds issuances of the universal credit institution with its assets acquired from the universal credit institution. This is also the preferred CB model outside Europe (e.g., in Australia, Canada, New Zealand, and Singapore).

²⁵ France and Norway bear mentioning here. In these countries, the special purpose company is a credit institution that acquires the cover assets from a universal bank parent company and issues the covered bonds itself.

²⁶ Point (b) of Article 12(1) of the CBD.

²⁷ Point (c) of Article 12(1) of the CBD.

b) Foreign cover assets and segregation of assets

The most challenging discussion in this context focuses on the questions of whether and to what extent foreign cover assets can be integrated into a cover pool or segregated under insolvency law – or, in other words, whether the protection of CB investors regulated by national law also extends to cover assets located abroad.

All CB laws aim to protect CB investors in the event of the insolvency of the CB issuer. If the registered office of the CB issuer is in the same country as the cover assets, the legislator may regulate the allocation of cover assets to the covered bonds because both are located in its territory and therefore subject to its regulatory competence.

Segregation of assets should also apply if the cover assets are located outside the country in which the CB issuer has its registered office. However, this is obviously no longer entirely in the hands of the national legislator.

This gives rise to two main questions: Could other parties than CB creditors seize cover assets abroad in order to gain access to the payments of the loan debtors? Could secondary or territorial insolvency proceedings be opened abroad in respect of the assets of the CB issuer there and, if so, would the preferential treatment of CB creditors under the CB law of the home country of the CB issuer be respected in foreign insolvency proceedings?

c) Cover assets from EU Member States

In answering these questions, the creation of the Directive on the Reorganisation and Winding-up of Credit Institutions²⁸ is of great importance for the legal area of the EU. This had to be transposed into national law by EU Member States by 5 May 2004.

This EU directive follows the principles of country of origin and universality. This means that the authorities and courts of the country in which the credit institution has its registered office are competent for recovery measures and consequently also for measures taken by banking supervisory authorities in advance of or to prevent insolvency, which have to take effect in all other EU Member States.²⁹ This also applies to the opening and performance of winding-up proceedings.³⁰

Creditors other than CB creditors cannot attach cover assets in other EU countries and thus cannot gain access to the payments of local loan debtors. It is not possible to open secondary or territorial bankruptcy proceedings against the assets of the CB issuer in other EU countries. The protective effect of the national CB laws is therefore fully effective within the countries of the EU.

d) Cover assets from third countries

The legal situation becomes more complicated with respect to cover assets located in third countries.³¹ Neither national nor EU legislators can create regulations that impact third countries and override international enforcement and insolvency law or directly interfere with regulatory sovereignty of third countries. Consequently, attachment and secondary bankruptcy proceedings in third countries cannot be excluded by domestic legal measures. The EU CB legislator was aware of this. As such, the requirements of Article 12 and Article 7 of the CBD have to be considered in conjunction.

²⁸ Directive 2001/24/EC of the European Parliament and of the Council of 4 April 2001 on the reorganisation and winding up of credit institutions, Official Journal of the European Union L 125/15 of 5 May 2001.

²⁹ Recitals 6 and 7, as well as Articles 3(1) and 3(2) of the Directive on the Reorganisation and Winding-up of Credit Institutions.

³⁰ Recitals 14 and 16, as well as Articles 9 and 10 of the Directive on the Reorganisation and Winding-up of Credit Institutions.

³¹ According to EU law, third countries are countries outside of the EU and the EEA.

Article 7(1) of the CBD explicitly allows EU Member States to include assets from third countries as cover assets. Although Article 7(2) of the CBD contains requirements for comparability, these relate to collateral assets and their enforceability.³²

The scope for flexibility in this area is also a consequence of principle-based CB harmonisation.

2.5 Cover pool monitors and public supervision

The provisions of Article 13 of the CBD on the “cover pool monitor” and, in particular, of Articles 18 to 26 of the CBD on “covered bond public supervision” are groundbreaking, as there has been nothing comparable on covered bonds in EU law until now.³³ Without the intensive work of the European Banking Authority (EBA), this density of regulation would not have been possible.

The very fact that Article 13 is located in Title II of the CBD (i.e. Structural features of covered bonds), and Articles 18 et seq. are located in Title III of the CBD (i.e. Covered bond public supervision), shows the decision of the EU legislator that the activity of a cover pool monitor cannot be considered part of public supervision.

It was highly disputed whether the function of a cover pool monitor should be required at all and how its independence should be structured. Here too, principle-based harmonisation is evident: As there are CB cover pool monitor regulations in most, but not all, Member States, the entire cover pool monitor provision has been regulated only as a possibility (i.e., as an optional provision, which, however, contains some mandatory requirements if the decision is made to set up such an authority). In addition, various versions of independence have been permitted with mention made both of a “cover pool monitor ... separate and independent from the credit institution”,³⁴ as well as of an “internal cover pool monitor”³⁵ when the function is not separate from the credit institution. However, neither the selection criteria nor the economic relationship³⁶ with the CB issuer are regulated for either cover pool monitor version, so this too remains within the scope of the national CB legislator’s freedom of design.

Regarding interpretation of this CBD provision, it is reported that there is the opinion that a cover pool monitor system is out of the scope of Art. 13 CBD, if the FSA appoints the cover pool monitor, whereas Art. 13 (1) 1 CBD says: “Member States may require that credit institutions issuing covered bonds appoint a cover pool monitor ...”. This would mean that the binding rules of Art. 13 CBD do not apply, although cover pool monitors exist.

The attention to detail with which Articles 18 to 26 of the CBD regulate various issues concerning the competences and procedures of CB competent authorities is remarkable. In particular, the list of administrative penalties detailed in Article 23 of the CBD is extremely long. These provisions are the result of the deliberations of the EBA’s CB working group, which brought together and (in part) summed up the existing national provisions.

2.6 Investor information

The provisions included in Article 14 of the CBD have been largely taken from Article 129(7) of the CRR. There is a discussion on how to transpose the requirement that CB issuers have to regularly publish information on credit risks into national CB law.³⁷

Here too, the CBD aims at principle-based harmonisation. As such, if it does not regulate its objectives in detail, rather, it is up to the national CB legislators to decide on the details and scope, which will be based on existing standards.

³² The content of this was adopted from Section 18(1) of the German Pfandbrief Act.

³³ Article 52(4) of the UCITS Directive and all EU provisions on covered bonds that use the same wording or refer to it only contain the provision that there has to be “special public supervision”. However, it has never been clarified how the terms “special” and “public” should be interpreted.

³⁴ First sentence of Article 13(3) of the CBD.

³⁵ Second sentence of Article 13(3) of the CBD.

³⁶ In particular, the remuneration for the work of the cover pool monitor.

³⁷ Point (d) of Article 14(2) of the CBD.

The connection between this provision and Article 6 of the CBD is obvious. The wider the range of eligible cover assets permitted by national CB law beyond the traditional cover assets, the greater the consideration that needs to be given to including transparency provisions for the associated credit risks.

2.7 Coverage requirements

Article 15 of the CBD contains provisions on coverage principles³⁸ and coverage calculation. Although the nominal principle is provided for in general, national CB legislators may also allow for other principles of calculation, the details of which have to be regulated in national CB laws.³⁹

For the first time, an EU provision has stipulated that winding-down costs are to be taken into account in the coverage calculation:⁴⁰ “the expected costs related to maintenance and administration for the winding-down of the covered bond programme.”

In order to avoid the time-consuming and costly calculation of winding-down costs according to current (and therefore frequently changing) demand, EU Member States may allow their national CB laws to calculate these winding-down costs on the basis of a “lump sum calculation”.⁴¹

Major discussions have been triggered by the question of whether the minimum overcollateralisation already provided for in many countries can be used as this lump sum. The European Commission has confirmed this in principle on various occasions. However, it was emphasised that these lump sums cannot be used twice. Thus, anyone using a statutory overcollateralisation provision to cover winding-down costs cannot use the same amount again to meet the overcollateralisation provisions of Article 129 of the CRR. This is already apparent from the fact that the calculation of coverage and the calculation of overcollateralisation are regulated by different pieces of legislation (i.e., the CBD and Article 129 of the CRR).

2.8 Requirement for a cover pool liquidity buffer

Article 16 of the CBD introduces a new element to EU legislation on covered bonds, as the requirement to maintain a liquidity buffer for the “next 180 days” can be found neither in Article 52(4) of the UCITS Directive, nor in Article 129 of the CRR. The aim of this provision is to enhance the quality of covered bonds by increasing the probability that CB creditors will receive timely payment in the event of the insolvency of a CB issuer.

There were intense discussions on how Article 16 of the CBD could be brought into line with the LCR requirements⁴² of general banking supervision law,⁴³ which lay down criteria for the eligibility of covered bonds as “liquid assets”.

Following a consultation period, the amendment to the LCR delegated regulation was published on 10 February 2022⁴⁴. The amended LCR delegated regulation addresses the double-counting issue in the liquidity buffer by treating liquid assets in the cover pool that are held as part of the liquidity buffer up to the amount of the net liquidity outflow within the next 30 days as unencumbered.⁴⁵ It also fixes ambiguous or outdated rules. In addition, the new rules clarify how the netting principle will work when calculating the liquidity buffer. The

38 Article 15(2) of the CBD.

39 Article 15(6) of the CBD. This allows the continuation of the net present value calculation of cover as it is currently regulated in a lot of national CB laws.

40 Point (d) of Article 15(3) of the CBD.

41 Second sentence of Article 15(3) of the CBD.

42 Liquidity coverage ratio. Commission Delegated Regulation (EU) 2015/61 of 10 October 2014 to supplement Regulation (EU) No 575/2013 of the European Parliament and the Council with regard to liquidity coverage requirement for Credit Institutions.

43 Article 412 of the CRR regulates the requirement that banks have to be able to provide liquidity for the next thirty days even under stressed conditions.

44 Commission Delegated Regulation (EU) 2022/786 of 10 February 2022 amending Commission Delegated Regulation (EU) 2015/61 to supplement Regulation (EU) No 575/2013; Official Journal L 141/1 – 5 dated 20 May 2022.

45 This, however, weakens covered bonds to a certain extent, as in the event of the insolvency of a CB issuer, for the first 30 days, the liquidity buffer would not be part of the cover assets segregated under insolvency law, but rather would be part of the general insolvency estate.

Regulation has a binding legal force throughout every EU Member State and entered into force on the twentieth day following that of its publication in the Official Journal of the European Union (i.e. from 8 July 2022).⁴⁶

Article 16(5) of the CBD simplifies matters further by permitting national CB legislators to allow maturity extension provisions to be taken into account in the calculation of the liquidity buffer. This also means that the liquidity buffer would only be required for interest liabilities falling due in the next 180 days if either no principal amounts fall due in this period or if principal amounts falling due according to the original payment schedule could be postponed by at least this period.⁴⁷

2.9 Conditions for extendable maturity structures

For a number of years now, numerous CB issuers throughout Europe have outlined in their terms and conditions of issuance that the maturity of their covered bonds may be extended under certain conditions.⁴⁸ Given the major significance of this development, it was necessary to include the topic in the CBD.

Article 17 of the CBD grants EU Member States the possibility of allowing the issuance of covered bonds with extendable maturity structures; this is therefore an optional provision. However, at the same time, mandatory requirements apply to these provisions if they are used. The national CB laws can either regulate all details of maturity extension themselves,⁴⁹ or limit themselves to the basic principles and leave further design to the CB issuers.

A minimum requirement is that the national CB law has to specify the objective triggers for maturity extension (i.e., these may not be at the discretion of the CB issuer).⁵⁰ These maturity extension triggers are to be specified in the contractual terms and conditions of the covered bond.⁵¹ When introducing provisions for maturity extension into national CB laws, the question thus arises of whether this is also possible for covered bonds that have already been issued (i.e., are in circulation). This can occur in two ways:

First, the CB issuer could ask the CB holders for their consent to a subsequent amendment of the terms and conditions of issuance (this approach could be quite costly). Second, Article 30 of the CBD may be applied, according to which covered bonds issued until 8 July 2022 may be labelled as “Directive-only covered bonds” if, for example, they do not comply with the requirements of Article 17 of the CBD.⁵²

A provision is also required whereby a maturity extension does not affect the ranking of CB investors or invert the sequencing of the original maturity schedule.⁵³ In this respect, it has already been intensively discussed whether this would exclude any change in the sequencing of the servicing of covered bonds in the event of the insolvency of a CB issuer.

Based on the precept of principle-based harmonisation of CBs, it is generally agreed that the CBD does not intend to interfere with the basic structure of CB systems⁵⁴. As such, this provision should be narrowly interpreted as well. Thus, the provision only prohibits changes in the sequencing that would result from the maturity extension and would be to the disadvantage of investors.

46 Already during the work on the CBD, it was suggested that the LCR Delegated Regulation should stipulate that the cover assets should not be treated as encumbered for the purposes of the LCR liquidity analysis, so that they could be counted towards the LCR.

47 In the CB issuance practices of soft-bullet covered bonds to date, a maturity extension of one year is common, and some even go beyond that. Polish CB law also regulates maturity extensions of one year. There are no known provisions on extensions for less than 180 days.

48 For an overview of this topic, see Rudolf, Extendable maturity structures – the new standard, ECBC, European Covered Bond Fact Book 2019, pp. 85 et seq.

49 The first country to include detailed provisions for maturity extensions in its CB law was Poland, which did so in 2016.

50 Point (a) of Article 17(1) of the CBD.

51 Point (b) of Article 17(1) of the CBD.

52 However, without the additional label of “European” (and definitely not of “Premium”) that results from the interaction of Articles 27 and 30 of the CBD.

53 Point (e) of Article 17(1) of the CBD.

54 Articles 5 – 12, 15, 16, 17 and 19 of the CBD.

2.10 Labelling

Article 27 of the CBD lists two protected labels:

The label “European Covered Bond” may be used for covered bonds that meet the provisions of national law transposing the binding rules of the CBD that apply in the country where the CB issuer has its registered office; and

The label “European Covered Bond (Premium)” may only be used for covered bonds that also meet the requirements of Article 129 of the CRR.

Not every national CB law has to explicitly protect the labelling in the languages of all other EU countries. It is sufficient when a general provision is selected, such as that contained within Article 27 of the CBD.

2.11 Transitional measures

The Directive includes generous grandfathering provisions. The aim is to get a smooth transition towards the new Directive, which should prevent any unintended market distortions.

The grandfathering provision of Article 30(1) of the CBD permits covered bonds issued until 8 July 2022 to be designated as covered bonds in accordance with the CBD, even if they do not meet the requirements of various expressly mentioned provisions 46 of the CBD.⁵⁵

However, during implementation procedure the question was asked in a few countries, whether Art. 30 CBD does not allow to apply the provisions, mentioned in Art. 30, to CBs, which were issued before 8 July 2022.

The purpose of Art. 30 CBD was ensuring that all outstanding (UCITS compliant) covered bonds (CBs) maintain their status quo as CBs even beyond 8 July 2022. The Article was conceived as a plain vanilla grandfathering provision preventing that the new CBD ‘infects’ existing cover pools and CB markets. Existing covered bonds (issued before 8 July 2022) should be “exempt” from certain new requirements of the Directive (see recital 41). The CB Directive aims at a principle-based harmonization (see recital 5). Therefore, Member States have a lot of discretion how to regulate their national covered bond law in detail. The scope of the grandfathering was conceived product specific. The nature of a principle-based harmonization gives room to national discretion, whether the provisions mentioned in Art. 30 CBD should be applicable only to CBs, which will be issued after 8 July 2022 or to CBs issued before as well.

With Art. 30 CBD it should be avoided that member states impose CBD provisions to outstanding CBs, which make no sense or would create a large burden to the CB issuers or even create turbulences in the CB market.

However, it does not mean that it is not allowed to apply these provisions, mentioned in Art. 30 CBD, to outstanding CBs where it makes sense.

All those provisions, which only make sense when being applied both to outstanding and new CBs, may be applied to both groups of CBs. This is obvious when there is only one cover pool for all outstanding and new CBs. It was not the purpose of Art. 30 CBD to oblige Member States or national legislators to create new and separate cover pools for new issuances.

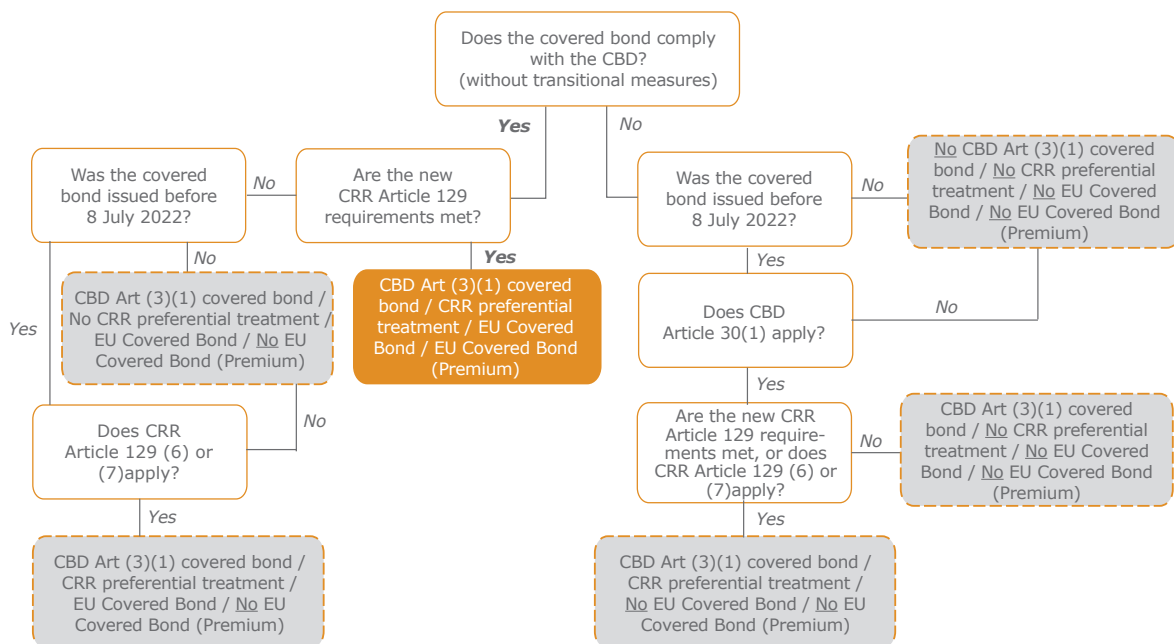
During the harmonization procedure there was not mentioned an understanding of Art. 30 CBD not allowing Member States to apply the provisions for outstanding CBs as well. Such an understanding would have reverted the underlying principle of the grandfathering, which was understood as an important pillar of a smooth transition to the new and more harmonized CB regime. Its intention was clearly ensuring the continuation of existing cover pools and prevention of the appearance of new cover pools in order to safeguard the homogeneity

⁵⁵ For the application of Article 30 of the CBD when a statutory provision introduces an extension of maturity without (subsequent) changes in the terms and conditions of issuance, see 2.9) above.

and unity of the European covered bond market, avoiding adverse impacts of the new legislation for CB investors.

Therefore, the wording of Art. 30 CBD is misleading and has to be interpreted in a way that follows the principles of the CB harmonization.

> FIGURE 4: TRANSITIONAL MEASURES VERSUS LABELLING PROVISIONS



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3. Content of the amendment of Article 129 of the CRR

The most important amendment to Article 129 of the CRR is the provision on the minimum level of overcollateralisation. This minimum level of overcollateralisation is to be calculated based on the liabilities referred to in Article 15(2) and (3) of the CBD.

In accordance with the first sentence of Article 129(3a) of the CRR, the minimum level of overcollateralisation is to be 5%.⁵⁶ Here too, principle-based harmonisation comes into play, in that the third sentence of Article 129(3a) of the CRR grants the EU Member States the authority to set a lower level of overcollateralisation or to authorise their competent authorities to set such a level, provided that the minimum level of overcollateralisation is not lower than 2%.

The reduction applies to all immovable property cover assets whose valuation is subject to the mortgage lending value. For other cover assets, "the calculation of overcollateralisation is based on a formal approach where the underlying risk of the assets is taken into account";⁵⁷ such a reduction must therefore be risk-adjusted.

⁵⁶ During the EU legislative process, a statutory minimum level of overcollateralisation as high as 10% was discussed. However, this was not included in the final version of the CB harmonisation package.

⁵⁷ Point (a) of the third sentence of Article 129(3a) of the CRR.

Art. 129 CRR now contains a grandfathering provision as well, which was discussed during implementation procedures.

Art. 129 (7) CRR as of 8 July 2022 states that covered bonds issued before 8 July 2022 and that fulfill all requirements of Art 129 CRR that were valid at the time of its issuance shall not be subject to the requirements laid down in the new paragraphs 3a and 3b and shall be eligible for preferential treatment under paragraphs 4 and 5 until their maturity. Hence, Art. 129 (7) CRR covers a grandfathering for outstanding covered bonds. Art. 129 (3a) CRR as of 8 July 2022 requires an OC and Art. 129 (3b) as of 8 July 2022 determines the eligibility of substitution assets.

Since Art. 129 (7) CRR refers to Art. 129 (3a) and (3b) only, the new requirement of Art. 129 (3) CRR (monitoring of property values) needs to be fulfilled for outstanding CBs as well.

However, this does not fit to the fact that Art. 129 (3a) and (3b) CRR refer to loans and not to CBs.

Therefore, those CB programs, where CB legislation does not foresee the opening of new cover pools but rather the continuation of existing cover pools, cannot benefit from this grandfathering provision of Art. 129 (7) CRR, and therefore need to fulfil the requirements of Art. 129 (3a) and (3b) CRR for outstanding CBs as well.

In the context of implementing the new OC requirements, it was discussed until when it is necessary to fulfill the requirements of Art. 16 CBD regarding liquidity buffer and Art. 129 CRR regarding OC to enjoy preferential treatment according to Art. 129 CRR.

OC and liquidity requirements aim at ensuring full and timely payment of CBs, if the CB issuer is insolvent. In insolvency procedure over the CB issuer, OC and liquidity buffer should be used for this purpose, if necessary. This means that the requirements cannot be upheld in insolvency procedure. Even though this is not stated explicitly in CBD and CRR, this must be interpreted according to the aims of these provisions.

However, the CBs of an insolvent CB issuer very likely will not be treated as CBD and/or CRR compliant CBs, if they do no longer have sufficient OC and liquidity buffer.

4. European Commission and EBA tasks

Through Article 31 of the CBD, the EU legislator has given several tasks to the European Commission and the EBA to complete:

- > By 8 July 2024: The development of an equivalence regime for the regulatory treatment of covered bonds issued by third-country credit institutions;⁵⁸
- > By 8 July 2025: The submission of a report on the implementation of the Directive in national law, as well as on the developments regarding permissions to issue covered bonds, cover assets, overcollateralisation, cross-border investments in covered bonds, the issuance of covered bonds with extendable maturity structures, and any recommendations for further action;⁵⁹
- > By 8 July 2024: The commissioning of a study on the risks and benefit arising from covered bonds with extendable maturity structures;⁶⁰
- > By 8 July 2024: The adoption of a report on the possibility of introducing a dual-recourse instrument named a European Secured Note (ESN).⁶¹

⁵⁸ Article 31(1) of the CBD.

⁵⁹ Article 31(2) of the CBD.

⁶⁰ Article 31(4) of the CBD.

⁶¹ Article 31(5) of the CBD.

The EBA received a Call for Advice (CfA) from the European Commission in July 2023 on the review of the EU covered bond framework, where input and technical advice is requested to conduct the review referred to in Article 31 of the Covered Bond Directive (CBD). The CfA mandates EBA to provide by June 2025 an assessment on five topics, four of which follow directly from Article 31 and relate to: 1. the performance and functioning of the covered bond framework; 2. the merits and design of a third country equivalence covered bond regime; 3. the need of updating the EBA assessment on European Secured Notes; 4. the risks and benefits of covered bond with extendable maturities. The commission has also added a request to provide an overview on the topic of 5. green covered bonds and ESG in cover pools.

In April 2024, the EBA arranged an industry roundtable in Paris to obtain more insights and opinions of CB issuers, investors, analysts and rating agencies.

III. ECBC COMPARATIVE DATABASE

The implementation of the CBD has also implied that the ECBC's legislative comparative database (see here <https://compare.coveredbondlabel.com/>) needed to be updated. The database provides a comprehensive overview of the key legal details of the new/ updated covered bond legislation in individual countries. As such, it improves transparency about how national legislators have transposed the CBD into national laws, given the highly principle-based character of the CBD. It also includes links to national covered bond legislation and in some cases also links to lists of European (Premium) labelled covered bonds.

In Summer 2024 the database of the international project "Round Table Covered Bond Legislation" went public (rtcbl.pfandbrief.de). In order to improve understanding of the national law on Covered Bonds, the vdp together with the members of the Round Table Covered Bond Legislation (RTCBL), have developed this public database. The Database contains comprehensive information about the present legal regime applicable to issuers of Covered Bonds in more than 20 countries. This complex material is presented in a series of maps on which countries which take the same approach are coloured the same. This allows the user to see the similarities and differences between legal systems at a glance in an overview. The Round Table Covered Bond Legislation aims to make a scholarly contribution to comparative examination of the areas of law which are significant for Covered Bonds.

IV. SUCCESS OF THE INSTRUMENT

To conclude, the covered bond is one of the key components of European capital markets, providing a stable funding tool to banks and a high-quality investment to investors. The volume of covered bonds outstanding at the end of 2022 amounted to over 3 tn EUR (covered bonds covered by mortgage loans, public-sector loans and ship loans). In descending order, the five largest issuing countries in the EU in 2022 were Denmark, Germany, France, Sweden and Spain.

Covered bonds play an important role in the financial system and thereby contribute to the efficient allocation of capital and ultimately economic development and prosperity. The importance of covered bonds is also evidenced by the broad variety of different bond formats and currencies under which the product is issued and by the large investor base. Both subjects are addressed in the key themes section.

> FIGURE 5: VOLUME OUTSTANDING COVERED BONDS IN EUROPE END OF 2022 IN EUR MILLION

	Public Sector	Mortgage	Ships	Others	Mixed Assets	TOTAL
Austria	26,772	74,522	-	5	-	101,299
Belgium	1,211	46,162	-	-	-	47,373
Cyprus	-	650	-	-	-	650
Czechia	-	17,908	-	-	-	17,908
Denmark	17,104	440,428	5,775	-	-	463,307
Estonia	-	2,100	-	-	-	2,100
Finland	-	51,817	-	-	-	51,817
France	72,432	244,263	-	-	50,863	367,558
Germany	110,144	281,505	1,932	-	-	393,581
Greece	-	10,140	-	-	-	10,140
Hungary	-	4,840	-	-	-	4,840
Ireland	-	12,229	-	-	-	12,229
Italy	3,100	162,848	-	-	-	165,948
Latvia	-	-	-	-	-	-
Luxembourg	4,595	-	-	300	-	4,895
The Netherlands	-	197,002	-	-	-	197,002
Poland	40	4,467	-	-	-	4,507
Portugal	600	35,900	-	-	-	36,500
Romania	-	200	-	-	-	200
Slovakia	-	11,382	-	-	-	11,382
Spain	12,585	188,958	-	7,300	-	208,843
Sweden	-	225,212	-	-	-	225,212
Total EU	248,583	2,012,534	7,707	7,605	50,863	2,327,291
Iceland	-	5,725	-	-	-	5,725
Norway	1,969	133,012	-	-	-	134,981
Total EEA	250,552	2,151,270	7,707	7,605	50,863	2,467,997
Australia	-	70,180	-	-	-	70,180
Brazil	-	16,133	-	-	-	16,133
Canada	-	168,393	-	-	-	168,393
Japan	-	5,788	-	-	-	5,788
New Zealand	-	10,648	-	-	-	10,648
Panama	-	21	-	-	-	21
Singapore	-	12,423	-	-	-	12,423
South Korea	-	11,622	-	-	-	11,622
Switzerland	-	174,458	-	-	-	174,458
Turkey	-	280	-	-	-	280
United Kingdom	564	90,311	-	-	-	90,875
United States	-	-	-	-	-	-
Total non EU	2,533	698,992	-	-	-	701,525
Total non EEA	564	560,256	-	-	-	560,820
Grand Total	251,116	2,711,526	7,707	7,605	50,863	3,028,817

Source: EMF-ECBC

Notes: Please refer to section 5 for additional information on the ECBC statistics.