

We've Got You Covered: New European Covered Bond Framework

The new framework should simplify the path for issuers seeking to market European covered bonds to investors in the US.

Key Points:

- The new framework will create minimum product and technical standards for covered bonds, focusing on high-quality cover pool assets.
- Covered bonds, which are not subject to “bail-in” powers, will have reinforced transparency and investor protections.
- Spanish covered bond programs will require the most updating, compared with the existing regime.
- Issuers should consider amending their documentation to facilitate marketing in the US.

Covered bonds offer unique benefits to both issuers and investors. Banks and other credit institutions have historically relied on covered bonds as an inexpensive source of funding and have purchased them to use as eligible collateral with the Eurosystem credit window, while institutional investors have valued the favorable risk-weighting of these stable and secure instruments, which typically combine a bankruptcy-remote asset-backed security with the further support of a direct claim against the credit institution issuer¹. To date, covered bonds have been issued either pursuant to long-standing statutory frameworks created by the national laws of several EU Member States or by more recent contractual arrangements developed by market participants. However, the liquidity of the European covered bond market has been complicated by such disparate legal regimes, which have provided for differing levels of transparency in ongoing reporting and have generally made assessing credit quality across jurisdictions difficult for investors and regulators.

In an effort to facilitate a broader EU-wide covered bond market, on November 23, 2018, the Council of the European Union published compromise texts of a proposal for a Regulation of the European Parliament and of the Council regarding the capital requirements for covered bonds (Covered Bond Regulation) and a proposal for a Directive of the European Parliament and of the Council on the issue of covered bonds and covered bond public supervision (the Covered Bond Directive and, collectively with the Covered Bond Regulation, the European Covered Bond Framework)², which were approved by the European Parliament on April 18, 2019. Pursuant to European law, the Covered Bond Regulation, will be directly binding upon the Member States, whereas the Covered Bond Directive will require Member States to adopt its provisions into national law within a specified timeframe. The European Covered Bond Framework is designed to harmonize minimum product standards based on existing national regimes,

establish common regulatory treatment of covered bonds across Member States, promote investor confidence, and foster greater inflows into this product class.

This *Client Alert* aims to summarize the European Covered Bond Framework focusing on the main implications for European banks and investors (in particular Brexit and expected changes to the Spanish covered bonds statutory framework, which stands to be most affected by the harmonization). The authors then review the opportunities and constraints related to marketing European covered bonds in the United States, and present a view of where this market is headed.

The European Covered Bond Framework: The Details

Product requirements

- Only credit institutions (including specialized mortgage credit institutions)³ may issue covered bonds.
- Covered bonds must be bankruptcy-remote,⁴ and creditors must have dual recourse, meaning the bonds must provide: (a) a priority claim over the assets securing the covered bonds (cover pool) with a minimum overcollateralization of 105% of the covered bonds' principal and interest; and, insofar as the cover pool assets are not sufficient, (b) a claim against the credit institution issuing the covered bond (which must be *pari passu* with claims of the credit institution's ordinary unsecured creditors).⁵
- The cover pool must be limited to eligible assets, namely mortgage loans, certain high-quality loans, and other liabilities subject to certain loan-to-value requirements.⁶
- Assets in the cover pool must be segregated⁷ and unencumbered by third-party claims.
- The issuer must establish a liquidity buffer calculated on covered bond net liquidity outflows for 180 calendar days (which can be held in a variety of cash equivalents).

Supervision and the offering process requirements

- Each EU Member State must designate a competent authority or authorities to grant permission for covered bond issuances; monitor compliance of covered bond programs; maintain a registry of all covered bonds; supervise, investigate, and sanction covered bond-related matters; and take relevant action in the context of an insolvency or resolution of the issuer.
- No cover pool monitor is required, but if Member States decide to impose one, it must be independent of the credit institution issuer and its audit firm.
- Covered bonds satisfying the European Covered Bond Framework's requirements may use the label "European Covered Bond" alongside any national denominations.
- Issuers must provide quarterly reporting to investors regarding, among other things, the value and composition of the cover pool, the geographic distribution and type of assets in the cover pool, the maturity structure of assets in the cover pool, the level of required overcollateralization, certain market risk disclosures, and the percentage of loans in default.

Entry into force and transition period

- The Covered Bond Regulation will be directly applicable 20 days following publication in the official journal with regards to the regulatory capital standards contained therein (covered bonds issued prior to December 31, 2007, or before the date of the application of the Covered Bond Regulation will be grandfathered through maturity).
- The Covered Bond Directive will require Member States to adopt implementing laws and regulations consistent with its terms no later than 18 months following its publication in the official journal, and such implementing laws must enter into force no later than 12 months from such date (covered bonds issued prior to the adoption date will be unaffected).

What Does a Harmonized “European Covered Bond” Mean for Issuers and Investors?

EU-wide market. One of the main achievements of the European Covered Bond Framework is the creation of an EU-wide marketplace for covered bonds that establishes minimal technical and legal requirements for covered bonds. Additionally, certain Member States that previously lacked covered bond frameworks in their jurisdictions, such as Croatia, Estonia, and Malta, will be required to introduce the instrument into their national laws, facilitating the use of covered bonds as a means of bank funding throughout the EU. Moreover, the Covered Bond Directive permits banks to conduct intragroup pooling and joint funding, which may stimulate covered bond issuances pooled from members of cross-border EU-wide banking groups or joint issuances by smaller credit institutions. A more diverse mix of assets and credit exposures is particularly topical considering that on January 1, 2019, the European Central Bank (ECB) ceased purchasing covered bonds under its Third Covered Bond Purchase Program. Previously, it was widely believed that the ECB’s sustained purchasing activity had stimulated covered bond issuances; that demand now needs to be replaced by other types of investors.

High quality, yet relatively simple-to-understand assets. The European Covered Bond Framework sets out asset quality and cover pool underwriting standards that aim to establish the instrument firmly in the camp of high quality, robust assets with medium- to long-term maturity profiles. Furthermore, by institutionalizing dual recourse and removing the ability to include certain securitization assets in the cover pool, the framework favors “simpler” covered bonds over so-called “structured” covered bonds that layered mortgage cover pools with holdings of securitization units and other types of mortgage-backed securities to diversify risk, such as was common in France. In this way, the reforms reduce the number of assets eligible to form the cover pool, particularly in the contractual covered bond space — aircraft leases and equipment leasing receivables will no longer be permitted to bear the “European Covered Bond” label or benefit from favorable treatment under the Capital Requirements Regulation.⁸

Brexit implications. The Covered Bond Directive provides that an equivalence regime for third-country (non-EU Member State) covered bond frameworks — one that will potentially permit non-EU banks to issue within the EU under their home laws and permit EU banks to issue under third-country laws and be afforded the same regulatory treatment and other attendant benefits of the European Covered Bond Framework — will be assessed following a two-year study period after entry into force. This delay creates significant uncertainty with respect to covered bonds issued by UK banks, since such instruments will not qualify for preferential risk weight until after 2022 in the event of a “hard” Brexit and may not be used as collateral for Eurosystem credit window purposes (absent specific derogations). Moreover, following Brexit, the competent authorities may need to approve the use of English law for covered bond issuances, since determining equivalency of investor protection, segregation, and enforceability standards are the domain of the Member States.

Spanish covered bonds. Spanish covered bonds currently have two forms: (a) *cédulas hipotecarias*, which are issued pursuant to a framework consisting of Law 2/1981 of 25 March (Law 2/1981), as amended and Royal Decree 716/2009 of 24 April (RD 716/2009), and (b) *cédulas territoriales*, which are issued pursuant to Law 44/2002 of 22 November (Law 44/2002, and together with Law 2/1981, Law 41/2007, and RD 716/2009, the Spanish Covered Bond Framework). The European Covered Bond Framework will require reworking the Spanish Covered Bond Framework in the following ways:

- Today's Spanish covered bonds are secured by the issuing bank's entire residential and commercial mortgage loan book in the case of *cédulas hipotecarias* (excluding mortgages securing securitized loans or mortgage securing mortgage bonds (or *bonos hipotecarios*, an instrument provided by law secured by specific mortgages that has not been widely used)) and the issuing bank's entire public sector loan book in the case of *cédulas territoriales*. In contrast, the European Covered Bond Framework will require issuers to allocate specific cover pools for individual issuances or programs (as the case may be) as well as provide initial and ongoing disclosure on the relevant cover pools, which previously was not required.
- The Spanish Covered Bond Framework incorporates a high degree of minimum overcollateralization (a 125% statutory requirement). This threshold may be decreased upon the transposition of the European Covered Bond Framework given the harmonized 105% minimum overcollateralization requirement (excluding the liquidity buffer).
- Instruments issued under the Spanish Covered Bond Framework will not be secured by mortgages allocated to any new issuances of covered bonds under the European Covered Bond Framework, since mortgages allocated to the new cover pools will no longer automatically secure existing instruments as part of the whole-bank mortgage book.
- Additionally, the Spanish Covered Bond Framework permits *cédulas hipotecarias* to be secured by real estate developer mortgage loans, which the Covered Bond Directive will not permit to form part of the cover pool.
- The European Covered Bond Framework introduces a liquidity buffer that does not exist under the current Spanish Covered Bond Framework.

Given the degree of change, Spanish covered bond issuers may need more comprehensive transitional mechanisms to be put into place. Alternatively, Spanish covered bond issuers may consider liability management or exchange offers to avoid or reduce the coexistence of covered bonds issued under the two regimes during the transition period.

Marketing the “European Covered Bond” in the United States

Credit institution issuers that are changing their existing programs, or are establishing new programs, in compliance with the new EU framework should consider amending their documentation to permit marketing their covered bonds in the United States, to further enlarge the addressable investor base. Although the US lacks a covered bond framework, there has been growing investor interest in covered bonds issued by non-US banks. European, Canadian, Australian, and Korean banks have issued approximately US\$195 billion in US\$-denominated covered bonds in the United States since 2010. In order to readily access the US market, covered bonds must (a) be exempt from the registration requirements of the US Investment Company Act of 1940 (Investment Company Act) and (b) avoid classification as a “covered fund” under Section 619 (Volcker Rule) of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, since covered funds cannot be held by US banks. While the

European Covered Bond Framework does not, at first glance, alter the current state of affairs, issuers and investors should review the circumstances and constraints under which European covered bonds can effectively be offered in the United States.

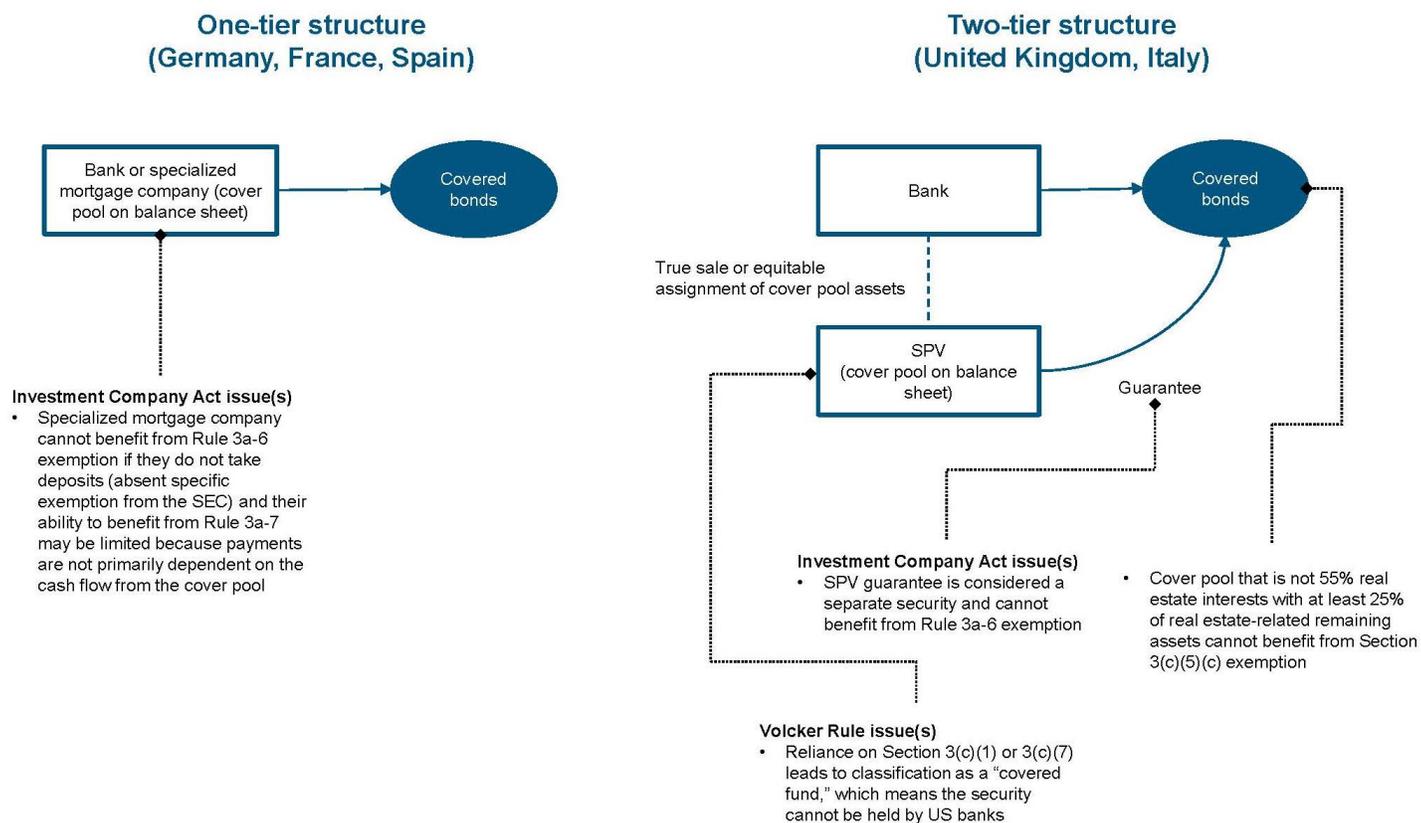
Investment Company Act

The main exemptions typically used by covered bond issuers include the following:

- Rule 3a-6 exempts non-US entities regulated as banks that are “engaged substantially in commercial banking activity,” posing a problem for specialized mortgage companies that do not take deposits but rather purchase and package mortgages for the purpose of issuing covered bonds (such as in France) as well as SPV structures in which the SPV is not otherwise eligible for another exemption (such as public debt cover pools in Italy).
- Rule 3a-7 exempts certain structured finance vehicles that issue primarily debt or debt-like securities backed by “eligible assets” (which could include mortgage loan and non-mortgage related assets, such as credit card receivables); however, this exemption only applies insofar as holders of such instruments are entitled to receive payments that “depend primarily” on the cash flow from the securitized assets, posing a problem as dual recourse means that the credit institution issuer may make the payments from its other resources rather than solely from the cover pool.
- Section 3(c)(5)(C) exempts securitizations and mortgage-backed securities for issuers that have at least 55% of their assets consisting of interests in real estate and at least 25% of the remaining assets being real estate-related, qualifying many SPV structures (such as in the UK and Italy) with mortgage loan cover pools, but posing a problem for public debt and maritime mortgage cover pools.
- Section 3(c)(1) exempts securities held by 100 or fewer persons.
- Section 3(c)(7) exempts securities offered solely to “qualified purchasers” (*i.e.*, investors that meet a standard that is higher than the “qualified institution buyers” standard for Rule 144A offerings under the US Securities Act of 1933).

However, any entity that relies on Section 3(c)(1) or 3(c)(7) exemptions under the Investment Company Act is considered a covered fund under the Volcker Rule — limiting the type of offering that can be made or requiring the issuer to seek an exemption from the Securities and Exchange Commission (SEC).

The graphic below depicts the two main structures of covered bond issuances in Europe along with constraints posed by the Investment Company Act that, depending on the structure, may prevent or reduce the ability to market such covered bonds in the US.



In connection with the creation of a wider European covered bond market and updates to programs that credit institutions may need to make prior to the European Covered Bond Framework's entry into force, there are numerous potential solutions for both one-tier and two-tier structures that would permit marketing covered bonds in the United States, either for offerings registered with the SEC or for those limited to certain types of qualified or similar investors, depending on the circumstances. In addition, SEC no-action or exemptive relief could be sought; similar relief has been granted to certain French and Canadian issuers.

Conclusion

According to the European Covered Bond Council, the amount of European covered bonds outstanding was equivalent to €2.1 trillion as of December 31, 2017; these bonds comprised instruments secured by cover pools consisting of mortgage loans, public-sector loans, and maritime vessel mortgages. The largest issuing countries were Denmark, Germany, France, Spain, and Sweden.⁹ The European covered bond market is large and liquid, and with the adoption of the European Covered Bond Framework, the market has the potential to become more globally relevant. The ECB 2018 stress test — which was published in February 2019 and covered 87 banks — indicated that financial institutions are better capitalized than they were in 2016, with average common equity tier 1 capital (CET1) at 10.1%, up from 8.8% in 2016. This data suggests that many institutions are on track to meet the full CET1 phased-in requirement under Basel III starting in 2019 (10.5%, including the capital conservation buffer).¹⁰

Nonetheless, European financial institutions, like many banks worldwide, may continue to face difficulties in raising and maintaining capital adequacy, especially in connection with sovereign debt-related shocks, Brexit, and other macroeconomic or geopolitical events. As recent headlines have shown, smaller EU credit institutions can find it difficult to raise funds; they may especially benefit from joint covered bond capital raising as a means of spreading risk and reducing the cost of funding. In addition, a harmonized European covered bond instrument could permit a more coordinated approach to obtaining no-action relief or other exemptive relief from the SEC, expanding the market for offerings of European covered bonds in the United States.

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Endnotes

- ¹ Covered bonds were exempted — up to the value of the collateral in the cover pool — from the reach of “bail-in” power which permits regulators to cancel, write-down or convert into equity all or part of the liabilities owed by the failing financial institutions to creditors established by Directive 2014/59/EU of May 15, 2014.
- ² See Proposal for a Regulation of the European Parliament and of the Council on amending Regulation (EU) No. 575/2013 as regards exposures in the form of covered bonds (COD/2018/0042) OJ C [...] [...], p. [...] and Proposal for a Directive of the European Parliament and of the Council on the issue of covered bonds and covered public supervision and amending Directive 2009/65/EC and Directive 2014/59/EU (COD/2018/0043) OJ C 367, 10.10.2018, p. 56-60. The proposals were agreed between the European Council and the member states on February 26, 2019 and approved by the European Parliament on April 18, 2019.
- ³ See Article 4(1)(1) of Regulation (EU) No. 575/2013 which sets forth a definition of a credit institution “as an undertaking the business of which is to take deposits or other repayable funds from the public and to grant credits for its own account.”
- ⁴ Bankruptcy remoteness is defined as the covered bond not being subject to automatic acceleration upon the insolvency or resolution of the credit institution issuer. Similarly, derivatives in the cover pool used for hedging purposes cannot be terminated upon an insolvency or resolution of the credit institution issuer.
- ⁵ It should be noted that for certain national frameworks, notably France, where the issuer is often a specialized mortgage institution with no other activity or assets other than making or acquiring mortgage loans, extending financing to public sector entities by making public sector loans or acquiring public sector obligations and acquiring debt securities backed by such assets, the actual utility that dual recourse can provide may be limited, but the European Covered Bond Directive indicates that this is sufficient for compliance with the dual recourse requirement.
- ⁶ Eligible assets would include EU assets (or, subject to member state discretion, certain non-EU assets of analogous quality), including: (a) liabilities of member state central governments, central banks, public sector entities, regional or local governments (direct or guaranteed); (b) non-member state liabilities substantially equivalent to clause (a) above, except that they are limited to 20% of the outstanding covered bonds issued and are subject to certain risk weight depending on credit quality; (c) liabilities of credit institutions and investment firms that meet certain credit quality requirements (subject to a value limit of 15% of the outstanding covered bonds issued); (d) loans secured by residential property (with the loan amount capped at 80% of the value of the pledged property); (e) residential loans guaranteed by credit protection providers such as central, regional or local governments and authorities, public sector entities, financial institutions and corporate entities with high credit quality (with the loan amount capped at 80% of the value of the pledged property and where a loan-to-income ratio is capped at 33%); (f) loans secured by commercial property (with the loan amount capped at 60% of the value of the pledged property); (g) loans secured by maritime liens on ships (with a loan-to-value ratio of at least 60%); and (h) loans to public undertakings of similar high credit quality providing essential public services and with sufficient revenue generating powers. Member states can set rules on homogeneity of cover pools at their discretion.
- ⁷ The European Covered Bond Directive contemplates various means of segregation, including on-balance sheet and using a SPV structure.
- ⁸ See 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.
- ⁹ European Covered Bond Council. European Covered Bond Fact Book 2018.
- ¹⁰ European Central Bank (ECB). “ECB 2018 stress test analysis shows improved capital basis of significant euro area banks.”