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S&P Global Ratings Comments On The Proposed Directive For European Covered Bonds

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Here, S&P Global Ratings presents its view of the European Commission's long-awaited proposed directive and regulation to establish a new framework for European covered bonds, published on March 12. The effort began with the EC consultation "Covered Bonds in the European Union," published in September 2015, and is the product of several years of work involving the European Banking Authority, the European Parliament, as well as market participants. This initiative is part of a broader push for a capital markets union in Europe, which also includes proposals for cross-border distribution of investment funds and a communication on the law applicable to cross-border transactions in claims and securities. It should be stressed that the European Council will need to approve the proposed covered bonds directive and the European Parliament will need to pass it before it becomes law.

As we expected, the proposed directive is principles-based and for the most part does not revolutionize existing national frameworks, but instead aims at better defining what covered bonds are, harmonizing practices across EU member states, and increasing the use of the instrument throughout the union (see "S&P Global Ratings Comments On The Proposed EU Legislative Framework For Covered Bonds," published on Sept. 11, 2017).

Key Takeaways

- The European Commission's proposed covered bond directive is mostly in line with our expectations of a high-level, principles-based approach that avoids onerous rules in what is a well-functioning market.
- We believe that while this is a balanced piece of legislation that should benefit the market, it raises a number of questions, in particular regarding Spanish covered bonds and the treatment of third countries.
- The creation of a European Covered Bonds label will raise the product's profile and signal greater comparability across jurisdictions.

A new definition primes covered bonds for new horizons

The directive proposes a definition of covered bonds as "a debt obligation issued by a credit institution and secured by a cover pool of assets which covered bond investors have direct recourse to as preferred creditors, replacing the definition in Article 52(4) of the Undertakings for the collective investment in transferable securities (UCITS) directive. It also clarifies key concepts such as acceleration of covered bonds and overcollateralization.

The directive also specifies structural features of covered bonds, such as the dual recourse principle and the bankruptcy remoteness of covered bonds, which to date are currently addressed in Article 129 of Regulation (EU) No 575/2013 (Capital Requirements Regulation (CRR)).

We see a willingness to "tidy up" existing European legislation applying to covered bonds as much as a recognition of the heightened importance given to the asset class by European authorities. This willingness is embodied by the creation of a "European Covered Bonds" label for EU covered bonds marketed in and outside of the bloc. This label is optional and can be used in addition to national labels.

The EC has stuck to its "if it ain't broke, don't fix it" approach, by recognizing that covered bonds are a well-functioning market and by generally applying the subsidiarity principle, whereby regulation of the market is often better achieved by competent and experienced regulators in established jurisdictions than by a brand new set of rules at a European level.

It is worth mentioning that the covered bond initiative goes beyond harmonizing existing covered bond regimes. It will also lead to the establishment of national frameworks in member states that currently do not have any such legislation and stimulate the issuance of covered bonds in jurisdictions where banks do not usually rely on covered bonds for funding.

The timeline for implementation looks relatively ambitious, but grandfathering should enable a smooth transition

It has been suggested that the EC is keen to proceed quickly and publish the directive and regulation before the next European Parliament elections, which will take place in May next year, in which case the timeline may appear ambitious. The draft legislation will need to be examined and adopted by the Council of Ministers and the European Parliament.

The draft directive suggests a one-year period for member states to transpose the directive into national legislation after it is published, which appears realistic at least for jurisdictions where minimal change is required and where no elections are due to be held.

Importantly, the directive proposes permanent grandfathering for covered bonds that satisfy the requirements of Article 52(4) of UCITS Directive. It is therefore likely that following the transposition of the directive into national legislation, grandfathered covered bonds will coexist with "new generation" covered bonds carrying the European Covered Bonds label for some time.

Many of the structural provisions of the directive were expected by market participants and appear consensual

Liquidity requirements with flexibility at the national level. The directive specifies that "the cover pool liquidity buffer shall cover the net liquidity outflow for 180 calendar days." This buffer must cover interest and principal. To determine the required principal, the extended maturity date is considered, meaning principal repayments on soft-bullet covered bonds are excluded from the calculation. In addition, other requirements imposed at the issuer level, such as assets used in the liquidity coverage ratio, may be taken into account for the calculation at the local regulator's discretion.

From our perspective, however, where the liquidity buffer is located at the issuer level, it is unlikely we would give credit to it in our analysis for covered bonds. In contrast, where the issuer has committed to fund a reserve under a prematurity test, we typically incorporate this form of support in our analysis, provided such provisions are in line with our applicable counterparty risk criteria.

Finally, the directive recognizes that these requirements need not apply to match-funded programs, such as those issued in Denmark.

Minimum overcollateralization of 5%, or down to 2% in some situations. While market participants anticipated various minimum overcollateralization levels according to asset type, the EC has opted instead for a blanket 5% minimum overcollateralization level. However, member states may opt for a lower minimum overcollateralization level, which should be no lower than 2% if the valuation of the assets is based on conservative mortgage lending values or on a model incorporating their assigned risk weights.

Residential and commercial mortgage-backed securities will no longer be eligible. The regulation amends article 129(1) of the CRR to exclude the possibility to include residential and commercial mortgage-backed securities in cover pools, on the basis that they add unnecessary complexity to covered bond programs. Currently, a number of national frameworks allow such units in cover pools, provided they do not exceed 10% of the nominal amount of the outstanding issue.

Clarification of the use of loan-to-value thresholds in the CRR. The regulation clarifies that the current loan-to-value (LTV) thresholds of 80% for residential loans and 60% for commercial loans mentioned in Article 129(1) of the CRR do not determine the eligibility of assets but merely correspond to the collateral level that may be included in the cover pool. These LTV limits are applicable throughout the entire maturity of the loan.

Standardization of the conditions for soft-bullet extension. The directive lists the conditions for extendable maturity structures. In particular, it makes it clear that "the maturity extension is not triggered at the discretion of the credit institution issuing covered bonds," clarifying a sometimes contentious point for conditional pass-through structures.

High-level monitoring, supervision, and reporting requirements. The EC did not make any unexpected proposal regarding monitoring and supervision. It is up to each national regulator to decide whether a cover pool monitor is necessary. Where these exist, the directive specifies a number of conditions, including that it must be "separate and independent" from the issuing credit institution.

Regarding ongoing supervision by national regulators, the directive contains mostly nonprescriptive language. In case of bank insolvency or resolution, it is again up to each national regulator to decide whether a special administrator should be appointed, under conditions outlined in the directive.

Concerning reporting standards, the directive specifies the minimum portfolio information that should be provided to investors. The key point here is that reporting should be quarterly at least, rather than semiannually as currently specified in the CRR.

European secured notes: different process and timeline. The EC has confirmed that it will go ahead with its European secured note (ESN) initiative, which will follow a separate process. ESNs will use covered bond technology but will be backed by riskier assets than for traditional covered bonds.

Following a feasibility study expected by the end of next month, the EC will launch a public consultation later this year.

The EC proposals have left open some questions that will need to be addressed before the legislation is finalized

Eligible assets: flexible language calls for clarity. The directive states that, beyond assets listed in the current applicable regulation (for example public-sector loans, residential, and commercial loans), which will all remain eligible, "other assets of a similar high quality could be considered eligible under the Directive." This provision was unexpected, causing some concern among market participants that the directive could water down the high standards enjoyed by covered bond programs by including nontraditional assets in cover pools.

We believe this wording reflects the balancing act done by the EC, whereby it seeks to further deploy covered bonds to benefit the European capital markets, while aiming to preserve their integrity.

We think these concerns may be overdone. While the directive opens up the theoretical possibility to include other high-quality assets beyond those currently listed, they will not be small and midsize enterprise (SME) and infrastructure bank loans as feared by some. In its impact analysis paper, the EC states the latter are "nontraditional assets" with "perceived higher risk [that] could affect the perception of traditional cover pool assets" which the ESN initiative is considering. Stealthily including such asset types in the directive would have run counter to the consultation process initiated with the industry and the EC's light-touch approach.

We nevertheless believe the wording about additional high-quality assets should be dealt with by the EC or European Parliament later in the process to clarify the scope of the directive about eligible assets.

Restrictions on mixed pools. The directive indicates that "Member States shall ensure investor protection by providing for a sufficient level of homogeneity of the assets in the cover pool so that they shall be of a similar nature in terms of structural features, lifetime of assets or risk profile." While this provision is most likely to have limited impact overall, it could potentially affect the Compagnie de Financement Foncier SCF covered bond program, which is backed by both mortgage and public-sector loans. We expect the issue to be addressed at a national level, depending on the stance taken by the French regulator and on the transposition of the directive into local law.

No third-country regime in the short term, leading to uncertainties. Under EU law, there is currently no equivalence regime for covered bonds issued in third countries, except for prudential purposes under restrictive conditions. The directive indicates the EC should, within three years after the deadline for transposition into national laws, submit a report to the European Parliament and to the Council of Ministers on the matter, with a legislative proposal if deemed appropriate.

This shows the EC does not intend to accommodate third-country regimes in the short term. Beyond important issuing countries such as Canada or Australia, this raises the question of what would happen to covered bonds issued in the U.K. after Brexit happens in March 2019, given the directive will most likely not yet have been published and transposed into national law. This issue is dependent on the outcome of the negotiations with the EU, but also on grandfathering provisions contained within the directive.

Spanish covered bonds: lots of work needed. In its impact assessment, the EC acknowledges that Spain will be the most affected country. The Spanish covered bonds law will need "substantial changes," as it will need to provide for the establishment of cover pools, segregation of cover pool assets, and new transparency requirements.

Two changes in particular could prove detrimental to covered bondholders:

- A cover register would reduce assets available, given bondholders at present have a claim over all mortgage assets; and
- The current legal overcollateralization level of 25% could be reduced as a result of the new European framework.

The situation is compounded by the large number of programs and covered bonds outstanding, and the high importance of covered bond funding for Spanish banks. The EC does not offer any solution but suggests the Spanish Treasury should act upon the consultations it has carried out so far. In any case, the grandfathering provisions of the EU framework should help smooth the transition to the new regime applicable to Spanish covered bonds.

The impact assessment also states the directive would help lower the required level of overcollateralization by credit rating agencies, which are particularly high "to compensate for the perceived weaknesses in [the Spanish] regulatory framework."

A welcome initiative that should improve the standing of covered bonds

We continue to believe this framework is broadly credit positive for covered bonds issued in the EU, although we do not expect any immediate impact on our ratings. The EC initiative will contribute to the development of covered bond markets in Europe and beyond and will raise the standards for asset quality, disclosure, and supervision in particular in some "noncore" European jurisdictions. It should also unlock the process for revising existing legislation in countries like Spain and Austria.

We expect the final legislation will clarify at least some of the outstanding points in a way that preserves the integrity of covered bonds as an asset class and build on its success as a reliable funding tool for the real economy.

Related Criteria And Research

Related Criteria

- Covered Bond Ratings Framework: Methodology And Assumptions, June 30, 2015
- Covered Bonds Criteria, Dec. 9, 2014

Related Research

- S&P Global Ratings Comments On The Proposed EU Legislative Framework For Covered Bonds, Sept. 11, 2017

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