

Consultation Document
Covered Bonds in the European Union

FSUG RESPONSE

About FSUG

The Financial Services User Group (FSUG) is an expert group set up by the European Commission following the core objective “to secure high quality expert input to the Commission’s financial services initiatives from representatives of financial services users and from individual financial services experts”. The mandate of the group is to:

- *advise the Commission in the context of the preparation of legislative acts or other policy initiatives affecting users of financial services, including consumers, retail investors and micro-enterprises;*
- *provide insight, opinion and advice concerning the practical implementation of such policies;*
- *proactively seek to identify key financial services issues which affect users of financial services;*
- *where appropriate, and in agreement with the Commission, liaise with and provide information to financial services user representatives and representative bodies at the European Union and national level, as well as to other consultative groups administered by the Commission, such as the European Consumer Consultative Group, the Payment Systems Market Expert Group, the European Securities Markets Expert Group and the Expert Group on Financial Education.*

GENERAL COMMENTS ON COVERED BONDS

The Financial Services Users Group (“FSUG”) supports the European Commission’s intentions to further integrate national covered bond markets. FSUG is generally positive about covered bonds as a direct investment product (or as part of a repackaged investment product) for retail investors, due to the low level of risk associated with covered bonds in comparison with unsecuritised debt securities and asset-backed securities (see below). It provides a low-risk alternative which has proven to be resilient during times of recession.

Indeed, covered bonds have performed relatively well during the recent financial crisis in comparison to other types of collateralized debt securities. No covered bond has ever defaulted (although the bail-out of a number of covered bond issuers undoubtedly contributed to preserving this record). Further high-quality harmonisation of the regulatory and supervisory frameworks applicable to covered bonds issued in Europe, along the lines of the EBA Best Practices would in our view further improve the resilience and attractiveness of this product for (retail) investors in Europe.

1) Covered bonds vs. unsecuritised debt securities

The yield on covered bonds is generally lower than on unsecuritised debt securities. However, in contrast to unsecuritised debt securities, investors who purchase covered bonds are backed by the cover pool of loans and also have recourse to the issuer of the covered bond programme if the cover pool is insufficient to meet the obligations (the so-called ‘dual recourse mechanism’). Covered bonds thus provide a low-risk alternative to unsecuritised debt securities.

2) Covered bond vs. asset-backed securities

Covered bonds are, looked at from investor protection perspective, also preferable over asset-backed securities (ABS). The main difference is that, in the case of covered bonds, the loans by which the bonds are backed stay on the balance sheet of the bank (the issuer), while in the case of ABS, the loans are sold to a bankruptcy-remote special purpose vehicle (SPV). In addition, these SPVs often generate additional costs and paper work for investors. Another important difference is that there are often strict requirements for the assets that may serve as collateral for covered bonds and issuers are often required to “refresh” the pool. This is not the case for ABS.

Asset encumbrance

The main downside, however, of covered bonds is that they create *asset encumbrance*, which is not problematic for those consumers that invest in covered bonds, but for deposit holders. In case of default, covered bond investors have priority over depositors on the assets that are segregated. It is however important to emphasize that asset encumbrance is not a problem specific to covered bonds, but a problem inherent to all collateralized debt securities that give investors priority over other creditors. FSUG understands the desire to limit such asset encumbrance, but believes it should not go at the expense of the principle that the cover pool should provide sufficient coverage.

However, bank depositors with balances above the insured amount of € 100,00 should be clearly and timely informed by their bank if these excess balances are junior to any covered bond and other collateralized liabilities of the bank.

PART I - COVERED BOND MARKETS: ECONOMIC ANALYSIS

The economic analysis, conducted by the European Commission, clearly shows in our view that there is considerable market fragmentation within the EU. FSUG believes that the divergence in secondary market pricing is mainly caused by the strong correlation between the credit performance of the cover pool assets (mainly mortgage loans and public sector debt) and the macro-economic performance of the country in which the issuer is located, especially the performance of national mortgage markets and the credit rating of “the sovereign” as debtor. FSUG therefore believes market fragmentation, and divergence in secondary market pricing among Member States, cannot be undone entirely by harmonizing the national applicable national regulatory and supervisory frameworks.

That said, divergences in regulatory and supervisory frameworks undoubtedly also played a significant role. In Germany, for example, there is solid national regulatory framework on covered bonds (Pfandbriefgesetz - Pfandbrief Act). Such a strong national framework is missing in some other Member States. This undeniably influences the secondary market pricing of covered bonds in times of crisis, when investors start to get more concerned about the default risk of the issuer and the protection they enjoy according to the legislative framework that applies to the covered bonds they have invested in.

PART II - LEGAL FRAMEWORK AND INTEGRATION

Benefits of harmonisation

Further harmonization at European level, whether through voluntary convergence or direct product regulation, would be a course of action worthy to pursue as it would at least take away some of the impact that certain country factors, i.e. the features of the applicable national regulatory and supervisory frameworks, have on an investment decision.

FSUG believes harmonisation would provide the following advantages to retail investors:

- i. If in line with the Best Practices of the European Banking Authority (EBA)¹, it would generally improve the quality of the regulatory framework(s) applicable to covered bonds across the EU. While some Member States already have solid frameworks in place, this is not true for others.

¹ EBA Report on EU Covered Bond Frameworks and Capital Treatment:
<https://www.eba.europa.eu/documents/10180/534414/EBA+Report+on+EU+Covered+Bond+Frameworks+and+Capital+Treatment.pdf>

- ii. It would increase legal certainty for retail investors investing (cross-border) in covered bonds, as they know what rules apply regardless of the country the issuer is located in. This way, they do not have to spend time and efforts finding out what rules apply.
- iii. Through simplification and standardisation of the rules across the EU, market fragmentation would decline which would result in deeper and more liquid markets.

Direct product regulation

In the consultation document, the Commission outlines two options for further harmonisation, being (i) voluntary convergence, incentivised by recommendations and preferential treatment in prudential rules or (ii) direct product regulation, meaning a dedicated EU covered bond legislative framework.

While FSUG believes and hopes that national legal frameworks will to a certain extent converge voluntarily along the lines of the best practices formulated by EBA, FSUG's view is that the urgency of creating a Capital Markets Union (CMU) calls for direct promotion of convergence through product regulation. This would give way to the emergence a "European covered bond", allowing the investor to fully base its decision on issuer's financial strength, the credit quality of the cover assets and the robustness of the programme's structure (although these factors will continue to be influenced by country factors, such as the macro-economic performance and financial strength of the government).

With voluntary convergence, investors will continue to experience legal uncertainty (for an uncertain and probably considerable amount of time), not knowing whether the national legal framework applicable to the covered bonds he or she considers investing in, is in line with the Best Practices formulated by EBA. FSUG therefore supports option 2 (direct product regulation).

Elements for an integrated covered bond framework

The list provided by the European Commission on p. 17/18 covers the most important elements that should be developed as part of such a dedicated EU covered bond legislative framework. However, FSUG is not supportive of only developing a subset of them (the three target areas identified by the EBA Report), suggested as an alternative by the European Commission, since:

- i. In order to ensure clarity and transparency towards investors and in order to avoid contagion from lower quality instruments in a crisis, the framework should protect the denomination 'covered bonds' and only allow instruments that conform to the European framework to use this term in, for example, marketing materials.
- ii. Rules governing the segregation of the cover assets, bankruptcy remoteness and the management of the cover pool post-insolvency from the legislative framework, should be central to any legislative framework on collateralized debt securities in general, and covered bonds in particular.

PART III – ELEMENTS FOR AN INTEGRATED COVERED BOND FRAMEWORK

Regarding these elements, FSUG supports the best practices as formulated by EBA. From the perspective of covered bond investors, the following ten best practices deserve extra attention and should, according to FSUG, be at the centre of a EU integrated covered bond framework:

Best practices

- i. Approval by the competent authority of the establishment, by a given issuer, of a covered bond programme. (If a preference is given to licensing specialised covered bond issuer, there should be regulator monitoring as well as at least an ex-ante notification for the establishment of a new covered bond programme).
- ii. Separation of different cover asset classes in different cover pools. (If any mixed cover are allowed, for example of residential and commercial mortgages, there should be sufficient measures to safeguard consistency in overall risk profile over time).
- iii. Cover pools limited to assets located in the European Economic Area (or jurisdictions that ensure that liquidation of collateral in the case of issuer default).
- iv. Mandatory appointment of a Cover Pool Monitor (except where the monitoring of the cover pool is directly carried out by the competent authority).
- v. Full coverage of all liabilities of the covered bond programme combined with a minimum over-collateralisation level.
- vi. The dual course principle, as defined in Article 52 (4) of the UCITS Directive.
- vii. Segregation of assets, either through a cover register or by the transfer of the cover assets to an SPV (but without transfer of credit risk).
- viii. No acceleration of payment obligations attached to the covered bonds.
- ix. Fully independent and transparent management of the covered bond programme upon issuer's default or resolution by a special administrator (with clearly defined duties) acting to uphold the preferential interest of the covered bond investors.
- x. Quarterly disclosure to investors on the credit risk, market risk and liquidity risk characteristics of the cover assets and the covered bonds of a programme as well as other relevant information.