Harmonisation-lite a sensible approach for covered bonds

The European Commission's March 12 covered bond proposals took it a step closer to completing its grandiose Capital Markets Union project. The harmonisation-lite approach is a sensible way forward and an option likely to cause minimum disruptiaon.

Market participants had hotly anticipated the principles-based measures for covered bond harmonisation, which came out alongside proposals for investment funds and cross-border transactions in claims and securities. Nothing dramatic or unforeseen emerged in the covered bond proposals since they had been pretty well telegraphed.

The covered bond measures will harmonise rules at EU level as a means to incentivise lending and drive cross-border capital flows (a particularly heartfelt policy end-game). Whether they will accelerate the creation of covered bond frameworks in new EU jurisdictions, increase region-wide covered bond issuance or improve price execution for issuers remains to be seen. The EC reckons its measures will save borrowers between EUR 1.5bn and EUR1.9bn annually.

In truth, though, while the intentions behind harmonisation may well be sound, history proves that it is hard to achieve to a high degree because of cultural differences across Europe and differences in the technical features of European markets.

EC pays heed to feedback

Noting that some provisions contained in its proposals are less detailed than the EBA recommendations on which they are based infers a degree of sensitivity from the EC to feedback from its 2015 public consultation on this subject. Respondents then had said they were only in favour of harmonisation if it didn't disrupt national markets.

Of the four policy options nominally on the table (no action; minimum harmonisation based on national regimes; full harmonisation replacing national regimes; or a 29th regime operating in parallel with national regimes), the mininum harmonisation path chosen is the most reasonable given its propensity to be effective and flexible at the same time as being less disuptive and less prone to creating fragmentation.

As such, the measures were broadly welcomed by The European Mortgage Federation – European Covered Bond Council and the Association of German Mortgage Banks (Verband Deutscher Pfandbriefbanken).

"The proposals are not game-changers. Harmonisation will merely set minimum levels and formalise existing market practices. So much has already been said; controversies dealt with; and broad agreement reached. There was no room for surprises," said Karlo Fuchs, head of covered bond ratings at Scope Ratings.

"The Commission undertook an extensive consultation process, so what came out is ultimately a mutually-agreed solution. Everybody saw this coming; the lawyers have just been waiting to get their pencils out to start amending existing laws to achieve compliance. In that respect, the proposals are a feast for lawyers but not necessarily the market," he added.

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Reasons for harmonisation well-rehearsed

The sentiment underlying the drive for harmonisation is well known. Policymakers believe the motley array of covered bond regimes affects the credit strength of the instrument. They fervently believe an enabling framework with common definitions and standards that eliminates uneven national-level regulation and varied levels of supervision, disclosure and cover pool construction is the way forward.

Policymakers want to address prudential concerns by ensuring that features of covered bonds are consistent with the high-quality risk profile so their preferential capital treatment is justified. They also want to assuage concerns that prudential treatment under the Capital Requirements Regulation may potentially be being granted to a range of quite different products.

The EC noted that since EU law does not comprehensively address what a covered bond is, this could potentially undermine investor protection safeguards. Of course, regulatory issues aside, investor protection in Europe is already being challenged by distorted technicals in bond markets generally brought about by ECB monetary policy and in covered bonds specifically by the Covered Bond Purchase Program (CBPP3).

“Covered bonds are clearly being viewed by the Commission as a rates product not a credit product. Despite the harmonisation, covered bonds will remain a credit product. Scope will continue to perform detailed credit and cash flow analysis to raise awareness of the potential risks that can arise in a crisis scenario,” said Fuchs.

“There is a lot of complacency out there around even basic elements like evaluating cover pools and assessing the circumstances under which the cover pool might be required, and around differences between markets, issuers and individual cover pools. The proposals will harmonise the frameworks but not the banks’ business models (which will ultimately impact the credit quality of the cover pools) or the differing economic environments they operate in.”

Creating a European Covered Bonds Label

So, what exactly are we getting with the package of proposals? The Directive will replace the UCITS Directive covered bond definition and become the single point of reference for all EU legislation relating to covered bonds. It provides a common definition; lays out structural features (dual recourse, asset quality, liquidity, and transparency requirements); outlines tasks and responsibilities for supervisors; and creates rules defining use of the European Covered Bonds label.

The direction of travel around soft bullet issuance and conditional pass-throughs was a keenly anticipated element of the proposals. The Commission wants, understandably, to avoid complex or opaque structures and to introduce better levels of transparency as a matter of investor protection.

Under the proposals, extension triggers will need to be specified in contract or statute. Issuers won’t be allowed to trigger extension, and will be required to provide detailed information about the maturity structure to enable investors to determine the risks. The final maturity date must at all times be determined; and maturity extension won’t be able to affect the ranking of covered bond investors or change structural features regarding dual recourse and bankruptcy remoteness.

The Regulation will mainly amend Article 129 of the Capital Requirements Regulation but with additional requirements on minimum overcollateralisation and substitution assets, in order to strengthen the requirements for covered bonds being granted preferential capital treatment.

The amendments introduce a minimum over-collateralisation (OC) requirement of 5% (down to 2% depending on the assets in the cover pool). This is in line with EBA advice. “The increase in minimum OC is manageable for all issuers since most already provide significantly more OC to elevate their covered bond ratings. The proposed level will only provide a floor and not allow achievement of the highest ratings,” said Fuchs.

Other snippets of interest:

- To encourage issuance by smaller institutions and give them access to covered bonds funding, the Directive foresees issuers pooling cover assets originated by several credit institutions under certain conditions.
- The Commission, working with the EBA, will assess the need for an equivalence regime for third-country covered bond issuers and investors. It will submit a report to the European Parliament and EU Council within three years of the harmonisation directive coming into effect (i.e. by the end of 2022) together with a legislative proposal.
- SME and infrastructure loans will fall outside the list of acceptable cover pool assets and will be pushed instead into new-fangled European Secured Notes. The proposals will relaunch the dynamics around ESNs.
- Covered bonds will no longer be able to be collateralised by senior tranches of French Fonds Communs de Titrisation or entities that securitise residential or commercial property.

The proposals now go to the European Parliament and EU Council. They are scheduled to come into effect following a one-year implementation period at the beginning of 2020. Member States, meanwhile, will be tasked with transposing the package of measures into their national covered bond frameworks.

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