ECONOMY AND FINANCE • VOL. 8 ISS. 1 • MARCH 2021 • DOI: 10.33908/EF.2021.1.2

EU HARMONISATION OF COVERED BONDS[1]

Essay

Otmar Stöcker[2]
(Edited by *András Botos*[3])

ABSTRACT

On 7 January 2020, the package for the EU-wide harmonisation of covered bond (CB) frameworks entered into force. This needs to be adopted and published in national law by 8 July 2021, and the new measures have to apply by 8 July 2022 at latest.[4]

This article presents the most important contents of the harmonisation package. These were intensively discussed during the EU legislative process by the European Commission, EU parliamentarians, and by members of the Council working group, but also among experts, especially in the Central European Covered Bond Conferences[5] and the workshops of the Round Table Covered Bond Legislation.[6] They are still being discussed today in the context of the transposition of the CB Directive into national CB law.[7] In order to understand and interpret the

1 This article is the English translation of the article Otmar Stöcker, O. (2020): *EU-Harmonisierung von gedeckten Bankschuldverschreibungen 1–2.* (Europäische Zeitschrift für Wirtschaftsrecht [EuZW], September).

2 *Otmar M. Stöcker*, PhD, is Managing Director and Head of Department "Cover Assets" in the Association of German Pfandbrief Banks in Berlin, Email: stoecker@pfandbrief.de

3 *András Botos* is Managing Director of Legal in the Hungarian Development Bank (MFB). E-mail: Botos.AndrasGabor@mfb.hu.

4 Additional background on this topic can be found in the Stöcker, O. (2019): *Towards harmonisation of covered bonds in Europe*, Housing Finance International, Winter, p. 24–30, which is the abridged and updated English translation of the article: Stöcker, O. (2018): *Pfandbriefe und Gedeckte Bankschuldverschreibungen* (Part 2), *Auf dem Weg zur Harmonisierung von Covered Bonds in Europa*, EuZW 15/2018, pp. 617–624. The article presents (I.) the development and current status of secured bonds issued by credit institutions in Germany, and outlines (II.) the preparatory work for the EU harmonisation of covered bonds, (III.) the draft of a Covered Bond Directive, and (IV.) the parallel discussion on the introduction of European Secured Notes (ESN), and finally (V.) draws a conclusion.

5 For more on this annual conference series established in 1997, see Stöcker, EuZW 15/2018, p. 617. (p. 620.).

6 For more on this network, see Stöcker, EuZW 15/2018, p. 617 (p. 621), footnote 45.

7 A complete presentation of all provisions of the harmonisation package would go far beyond the scope of a technical paper. As such, this article should not be understood as a commentary on the CB Directive.

DOI link: https://doi.org/10.33908/EF.2021.1.2

CB Directive, it is also important to know which regulations were proposed but were ultimately rejected in the procedure. As such, the most important points of contention are also mentioned.
Although the CB Directive refers only to covered bonds, the requirement of issuance by a credit institution is explicitly laid down in Article 2 of the CB Directive. As such, the terms "secured bond issued by a credit institution" and "covered bond" will be used in the following to emphasise their issuance by a credit institution.[8]

JEL-codes: G12, G18, G 21

Keywords: covered bonds, EU legislation

1 COMPLETION OF THE EU LEGISLATIVE PROCESS

On 18 March 2019, the European Parliament adopted the harmonisation package for covered bonds in its last session before the elections for the new European Parliament, but only provisionally based on the English language version, as the translations into the individual EU member languages were not yet available. The newly elected European Parliament took up the package[9] and approved it on 11 October 2019, as did the Council in 8 November 2019. As the legislative package was published in the Official Journal of the European Union on 18 December 2019[10], it entered into force on 7 January 2020.[11]

8 For more on the terminology of cover bonds, see Stöcker, EuZW 15/2018, p. 617.

9 Although the principle of discontinuity fundamentally applies (Rule 229 of the Rules of Procedure of the European Parliament), the results of the Parliament's votes (plenary decisions) taken before the election at the end of a parliamentary term remain legally binding on the Parliament for the next parliamentary term. This means that, after the elections, the newly elected Parliament continues to work on the proposals at exactly the point where the old Parliament left off and moves on to the next stage in the decision-making process. There is no legally binding position of the European Parliament on any legislative proposals on which the plenary did not vote before the elections. However, in this case, the Conference of Presidents may decide at the beginning of the new parliamentary term to continue work on these legislative proposals.

10 CB Directive: Directive (EU) 2019/2162 of the European Parliament and of the Council of 27 November 2019 on the issue of covered bonds and covered bond public supervision and amending Directive 2009/65/EC and 2014/59/EU, OJEU L 328 of 18 December 2019, pp. 29 – 57. Amendment to Article 129 of the CRR: Regulation (EU) 2019/2160 of the European Union and of the Council of 27 November 2019 amending Regulation (EU) No 575/2013 as regards exposures in the form of covered bonds, OJEU L 328 of 18 December 2019, pp. 1–6.

11 In accordance with Article 33 of the CB Directive, the CB Directive entered into force on the twentieth day following that of its publication in *The Official Journal of the European Union*, as did Article 2 of the amendment to Article 129 of the CRR.

This EU law is to be transposed into national law by 8 July 2021. In accordance with Article 32(1) of the CB Directive, the national legislator can allow a transitional period for the application of new provisions of up to 12 months, so the measures need to apply by 8 July 2022 at the latest. In accordance with Article 2 of Regulation (EU) 2019/2160, the amendments to Article 129 of the CRR[12] will become directly applicable on this date.

The harmonisation package consists of a Covered Bond Directive 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 CB Directive regulates the requirements for covered bonds, which, up to now, were only laid down in a rudimentary fashion in Article 52(4) of the UCITS Directive[13]; this provision has been accordingly amended and now refers to the CB Directive,[14] as has the Bank Recovery and Resolution Directive (BRRD).[15] Various other provisions on covered bonds in other directives that refer to Article 52(4) of the UCITS Directive are thus also indirectly amended.[16]

2 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.[17] 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;

12 Capital Ratio Regulation, 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, OJEU L 176 of 27 June 2013, pp. 1 et seq. (corrigendum in OJEU L 321 of 30 November 2013, pp. 6 et seq.).

13 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).

14 Amended in Article 28 of the CB Directive.

15 Amended in Article 29 of the CB Directive. The Bank Recovery and Resolution Directive refers to 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, OJEU L 173/190 of 12 June 2014.

16 For more on the link between the CB Directive and LCR regulations, see III. 8. below.

17 Recital 5 of the CB Directive.

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 CB Directive 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, which is reflected not only in the open wording[18], but also in the options[19] and the exclusions of what are in themselves very important issues of principle.[20]

This is also illustrated by the fact that the CB Directive contains both mandatory and optional provisions. Some mandatory provisions also contain optional elements[21], and vice-versa.[22]

3 DIRECTIVE FOR SECURED BONDS ISSUED BY CREDIT INSTITUTIONS

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 CB Directive are also important for understanding individual provisions.

3.1 Dual recourse

Article 4 of the CB Directive 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 CB Directive 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 mort-

18 See, for example, Article 6 of the CB Directive (cover assets).

19 See, for example, Article 13 (cover pool monitors) and Article 17 (extendable maturity structures) of the CB Directive.

20 Particular mention should be made here of the segregation of cover assets, which Article 12 of the CB Directive provides for, but does not regulate how this should be accomplished.

21 See, for example, second sentence of Article 13(2) and second sentence of Article 15(3) of the CB Directive, as well as third sentence of Article 129(3a) of the CRR.

22 See, for example, Article 13 and Article 17 of the CB Directive.

gage-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.

3.2 Bankruptcy remoteness of covered bonds

Article 5 of the CB Directive 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.

Although taken for granted today, this element of a secured bond issued by a credit institution is one of the more recent innovations in the 250-year history[23] of this asset class; it was first introduced in the German Mortgage Bank Act (*Hypothekenbankgesetz*, HBG) in 1998[24], where it was expressly regulated in 2004, and adopted in the second sentence of Section 30(1) of the German Pfandbrief Act (*Pfandbriefgesetz*, PfandBG). Since then, it has established itself worldwide.[25]

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 cov-

23 The 250-year history of the German covered bond (the Pfandbrief) is detailed in Sattler, F. (2019): *Der Pfandbrief 1769-2019, Von der preußischen Finanzinnovation zur Covered Bond Benchmark* (Stuttgart), with a contribution from Engelhard, F. on the development from 2005.

24 The exclusion of automatic acceleration of German Pfandbriefe was first regulated by an amendment to the HBG on 1 April 1998 after *Rolf Stürner* had addressed the issue in his report and developed proposals for solutions. See here Stürner, R. (1998): *Die Sicherung der Pfandbrief- und Obligationengläubiger vor einer Insolvenz der Hypothekenbank*, VDH/vdp publication series, Volume 7, pp. 61 et seq. and pp. 156 et seq.

25 Only the Czech Republic has long done things differently. It is still unclear today whether this is still the case or whether the relevant regulation should be interpreted differently. This should be resolved in the context of the transposition of the CB Directive.

ered bonds such as (up to now)[26] the German Pfandbrief, have a fixed maturity. However, most legislators in other countries 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. Article 17 of the CB Directive addresses this issue.[27]

3.3 Eligible cover assets

In 2013[28], Article 129 of the CRR established the first uniform, EU-wide, and directly binding provision[29] 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.

3.3.1 Additional cover assets

Article 6 of the CB Directive goes beyond the framework of Article 129 of the CRR and allows for additional cover assets. Anyone taking advantage of this loses their preferential treatment in accordance with Article 129 of the CRR but can make use of the other special provisions directly linked to the CB Directive or other EU directives that refer to the CB Directive.[30]

Furthermore, according to Article 27 of the CB Directive, a covered bond whose cover assets meet the requirements of Article 129 of the CRR may be designated 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".

---

26 The vdp has been calling for a statutory extension of maturity in the event of the insolvency of a Pfandbrief issuer for many years now; see Stöcker, O. (2016): *PfandBG – Pfandbriefbanken schlagen Fälligkeitsverschiebung vor*, vdp Infobrief Q2, pp. 2 et seq.

27 See *4.11* below.

28 In force since 1 January 2014.

29 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, F. (2006): *Covered Bonds and the EU Capital Requirements Directive*, ECBC, European Covered Bond Fact Book, 1st Edition, p. 179 (pp. 180 et seq.).

30 See here Stöcker, O.: op. cit. (Part 2), EuZW 15/2018, p. 617 (pp. 621 et seq.).

3.3.2 Three categories of eligible cover assets

Article 6(1) of the CB Directive provides for three categories of eligible cover assets:

3.3.2.1 Assets that are eligible pursuant to Article 129 of the CRR[31]

These are mainly traditional assets, especially claims related to property financing, public financing, and ship financing. In this context, the following LTV ratios[32] apply to property and ship assets: residential immovable property mortgages 80%; commercial immovable property mortgages 60%[33]; and maritime liens on ships 60%.

3.3.2.2 High-quality cover assets[34]

The exact criteria for the high quality of cover assets is not provided. Rather, it lists requirements that a cover asset has to fulfil by consisting of a claim for payment[35] 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. Collateral assets can be provided as "physical collateral assets"[36] or as "assets in the form of exposures".[37]

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."[38] This requirement was one of the main points of contention in the provision, as there

---

31 Point (a) of Article 6(1) of the CB Directive.

32 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.

33 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 outstanding by at least 10 %.

34 Point (b) of Article 6(1) of the CB Directive in conjunction with Article 6(2) and Article 6(3) of the CB Directive.

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

36 Point (a) of Article 6(3) of the CB Directive.

37 Point (b) of Article 6(3) of the CB Directive.

38 Point (a) of Article 6(3) of the CB Directive.

are no registers for many assets. As such, the following text was added: "Member 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."[39] The EU legislator has thus opted for a broad recognition of national covered bond regulations and national certification and recognition schemes. Nevertheless, this does not go as far as some would have liked, who wanted a legal opinion from a lawyer to be sufficient.[40]

Aircraft registered in Germany are certainly covered by such registers, as there are two registers; one that shows ownership[41] and another that shows mortgages[42] on the aircraft.[43]This also applies to cars and trucks registered in other countries where the required registers exist. Several European countries also have registers for movable assets, so there is a potential wealth of movable assets throughout Europe that could be used as cover assets. However, it remains to be seen what is meant by an "alternative form of certification" as specified in Article 6 (3) of the CB Directive.

3.3.2.3 Public undertakings[44]

These include claims on loans to or guarantees by public undertakings within the meaning of Article 2 of the Transparency Directive.[45]

39 Last sentence of Article 6(3) of the CB Directive.

40 Another controversial proposal for Article 6 of the CB Directive, which ultimately failed to gain acceptance, was the almost unlimited use of assets for cover without any quality criteria.

41 The aircraft ownership register is maintained at the German Federal Aviation Office (Luftfahrt-Bundesamt) in Braunschweig.

42 The aircraft mortgage register is maintained at the Braunschweig local court (Amtsgericht). In addition (or alternatively), an international interest can be created in accordance with the Cape Town Convention and entered in the International Registry of Mobile Assets in Dublin.

43 These are two separate registers. However, even if some translations of the CB Directive mention "one" register (e.g., the German version refers to "*ein öffentliches Register*"), it should not pose a problem if ownership and mortgages are recorded in separate registers. First, the indefinite article is used, and second, the English version refers to "a" register (not "one" register).

44 Point (c) of Article 6(1) and Article 6(4) of the CB Directive.

45 Recital 16 of the CB Directive. 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

The reference to this legal definition of public undertakings makes the scope of this category very broad.[46] 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 CB Directive. These contain several terms that are subject to interpretation, such as "provide essential public services" and "subject to prudential supervision".

Claims against credit institutions and insurance undertakings are a special case. On the one hand, recital 16 of the CB Directive 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 CB Directive.

On the other hand, however, they fulfil the requirements for public supervision in accordance with point (b) of Article 6(3) of the CB Directive. 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.

It is questionable whether direct claims against credit institutions and insurance undertakings without any collateral and unlimited amount are eligible. An interpretation according to the wording and system of Article 6 of the CB Directive would mean that claims against credit institutions would not be directly eligible as cover, but could only serve as collateral for other claims, which, in turn, could also be claims against credit institutions. Consequently, (direct) claims against credit institutions and insurance undertakings would only be eligible for cover within the requirements and limits of Article 129 (1a) to (3) of the CRR; in particular, the total exposure limit of 15 % in accordance with point (d) of Article 129(1a) would have to be observed.

financial transparency within certain undertakings, *The Official Journal of the European Union* of 17 November 2006, L 318/17.

46 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;.."

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 CB Directive 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 CB Directive 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 CB Directive.

3.4 The uniformisation of the covered bonds

Given the multitude of conceivable cover assets, Article 10 of the CB Directive aims to make covered bonds more or less in order to ensure homogeneity in the national transposition by the EU Member States, without however defining how this is to be interpreted.

This provision was also highly controversial. In order to achieve a high degree of homogeneity, some parties wanted to lay down strict and detailed specifications on how cover pools may be composed. This went as far as proposing a percentage ceiling for loan claims secured by mortgages on commercial properties, so that residential properties should always make up the largest share of a mortgage cover pool. It was also suggested that residential mortgages and commercial mortgages should not be included in the same cover pool. However, these proposals did not gain acceptance, nor did the suggestion of including the obligation for national legislators to allow multiple cover pools per CB class.[47]

47 Other controversial proposals discussed in connection with Articles 6 and 10 of the CB Directive, included specific upper limits for concentration risks and provisions for the granularity of cover pools. Ultimately, these too failed to gain acceptance.

Rather, Article 10 of the CB Directive[48] 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. Ultimately, this provision is particularly important for those countries that do not regulate any classes[49] of covered bonds, but only a list of assets eligible for cover, and then leave it to the CB issuers to decide whether and how they mix these assets in their cover pools.[50]

3.5 Allowing derivative contracts in the cover pool

The complicated topic of allowing derivative contracts in the cover pool is regulated separately in Article 11 of the CB Directive.

Discussions on this topic still focus mainly on the requirement that a derivative contract may be included in the cover pool "exclusively for risk hedging purposes."[51] However, this exclusivity criterion cannot be understood in absolute terms, as this would not be feasible in practice. On the one hand, a CB issuer has to be guided by the derivative products available on the derivatives market and, on the other hand, the cover pools "breathe", that is, they change daily as a result of new inclusions and redemptions of cover assets. This requirement should therefore be understood to mean that the clear objective of inclusion of a derivative has to be to reduce an open net interest or currency position; the creation of a new open position without need from the point of view of the cover assets or covered bonds (e.g., purely to enhance earnings) should be excluded. Moreover, a sense of proportionality and a practical approach are appropriate here.[52]

48 Recital 18 of the CB Directive is also clear in this respect.

49 The German Pfandbrief Act regulates four classes: Mortgage Pfandbriefe (*Hypothekenpfandbriefe*), Public Pfandbriefe (*Öffentliche Pfandbriefe*), Ship Pfandbriefe (*Schiffspfandbriefe*), and Aircraft Pfandbriefe (Flugzeugpfandbriefe) – with detailed provisions on the respective eligible cover assets.

50 This has so far been the case according to the CB rules of France, Sweden, and Finland, for example.

51 Point (a) of Article 11(1) of the CB Directive.

52 The introduction of an amount-based limit per cover derivative, as discussed in the EU legislative process, was not included in Article 11 of the CB Directive.

4 SEGREGATION OF COVER ASSETS

Article 12 of the CB Directive 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.

4.1 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 specialised credit institutions, universal credit institutions, SPV models, and pooling models.[53]

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)[54] 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 CB Directive only provides the following:

- All cover assets have to be identifiable.[55] This can be done through entry in a cover register, as stipulated in most CB laws in EU Member States. This can

53 For more details on the CB models in association with the degree of specialisation and on the legal link between covered bonds and their cover assets see Stöcker (2018): EuZW 2018, p. 617 (p. 618). For a detailed description of the categorisation developed by the Round Table Covered Bond Legislation see, Stöcker (2011): *Covered Bond Models in Europe, Fundamentals on Legal Structures*, Housing Finance International, Winter, p. 32–40.

54 For more on their preliminary work, see Stöcker (2018): EuZW 2018, p. 617 (p. 622).

55 Point (a) of Article 12(1) of the CB Directive.

also be achieved by establishing a separate legal entity for the cover pool[56] or even for the CB issuers,[57] 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.[58]

- The respective CB law has to provide for segregation of assets.[59]
- The cover assets have to be protected from any third-party claims.[60]

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.

4.2 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 no longer entirely in the hands of the national legislator – the national border is also the limit of its regulatory power.

56 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).

57 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.

58 Whether this can already be regarded as a segregation of assets is another question and depends, among other things, on whether the transfer to the specialised company is reversible (i.e., whether, when, and under what conditions these cover assets can be transferred back to the CB issuer).

59 Point (b) of Article 12(1) of the CB Directive.

60 Point (c) of Article 12(1) of the CB Directive.

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?

4.3 Cover assets from EU Member States

In answering these questions, the creation of the Directive on the Reorganisation and Winding-up of Credit Institutions[61] 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.[62] 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.[63] This also applies to the opening and performance of winding-up proceedings.[64]

The national authorities no longer have sole responsibility within the scope of the BRRD[65] (transposed into German law by the SAG[66]) and the SRM[67] Regulation[68];

61 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, *The Official Journal of the European Union* L 125/15 of 5 May 2001.

62 See here Schimansky, H. – Bunte, H.-J. – Lwowski, H.-J. (2017): *Bankrechts-Handbuch*. 5th edition, München: C. H. Beck, Section 138, marginal note 16.

63 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.

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

65 See here Schimansky, H. – Bunte, H.-J. – Lwowski, H.-J. (2017): op. cit., Section 138, marginal notes 18 et seq.

66 The German Act on the Recovery and Resolution of Credit Institutions (Gesetz zur Sanierung und Abwicklung von Instituten und Finanzgruppen, SAG) of 10 December 2014 (BGBl. I, p. 2091).

67 Single Resolution Mechanism, established under Regulation (EU) No 806/2014 of the European Parliament and of the Council of 15 July 2014 establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Resolution Fund and amending Regulation EU No 1093/2010.

68 See here Schimansky, H. – Bunte, H.-J. – Lwowski, H.-J. (2017): op. cit., Section 138, marginal note 31.

instead, the SRB now plays a central role among the credit institutions subject to ECB supervision. However, the newly established resolution authorities also have to comply with the principles of private international law and international insolvency law. As such, these newer provisions on resolution law do not fundamentally change the principles that determine which law is applicable with regard to the protection of CB creditors and the allocation of cover assets important for this purpose. This applies equally whether the resolution authorities initiate recovery, resolution, or insolvency proceedings against the CB issuer.

This means, for example, that in insolvency proceedings, the law of the country in which the insolvent credit institution has its registered office is applied. The assets (including the cover assets) located in another EU Member State are assessed only according to the law of this country of domicile with regard to their belonging to a separate estate (e.g., the cover pool); thus its CB law governing this separation of assets is decisive. The conduct of further insolvency proceedings in another EU Member State is not permitted; likewise, any individual enforcement measures (e.g., attachment of assets) are prohibited in all EU states already by the opening of insolvency proceedings.

As such, the legal situation in the EU can be summarised as follows: 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.[69]

69 An expert opinion examined the question of whether the implementation of the Directive on the Reorganisation and Winding-up of Credit Institutions ensures EU-wide recognition of the preferential right of Pfandbrief creditors in insolvency in accordance with German Pfandbrief law. The expert opinion confirmed this, finding that the opening of insolvency proceedings against a credit institution can only take place in the EU Member State where the credit institution has its registered office and that neither individual enforcement measures against this (insolvent) credit institution nor the opening of secondary or territorial insolvency proceedings are permitted in other EU Member States. Consequently, insolvency proceedings against a German Pfandbrief bank could only be opened in Germany, where German Pfandbrief law would apply, thereby ensuring the protection of Pfandbrief creditors. This opinion was published in Stürner, R. (2003): *Die europäische Sanierungs- und Liquidationsrichtlinie für Banken und die deutschen Hypothekenbanken*, in Gerhardt, W. – Haarmeyer, H. – Kreft, G. [eds.] (2003): *Insolvenzrecht im Wandel der Zeit, Festschrift für Hans-Peter Kirchhof zum 65. Geburtstag*, p. 467 et seq.

4.4 Cover assets from third countries

The legal situation becomes more complicated with respect to cover assets located in third[70] countries.[71] 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 CB Directive have to be considered in conjunction.

In this context, it is important to know that, with respect to Article 7 of the CB Directive, a ban and a limit on cover assets from third countries were discussed, but not included in the final version of the CB Directive. Rather, Article 7(1) of the CB Directive explicitly allows EU Member States to include assets from third countries as cover assets. Although Article 7(2) of the CB Directive contains requirements for comparability, these relate to collateral assets and their enforceability.[72]

Article 7 of the CB Directive does not require that the scope of asset segregation has to be identical to that of national or EU cover assets. In the discussions on this provision, the limited regulatory competence of national CB legislators was addressed, which also results from the principles of private international law and international insolvency law. Any vagaries therefore lie within the decision-making competence of the national CB legislators. They can prohibit assets from third countries, or allow them to be held for an unlimited or limited amount, and thereby take into account the complexity of the legal issues associated with cross-border situations, accepting them, or even limiting them by imposing additional requirements.[73]

---

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

71 For more detail, see Stöcker, O. (2013): *Pfandbriefrechtlicher Insolvenzschutz und ausländische Deckungswerte*. Festschrift Rolf Stürner, p. 815 et seq.

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

73 In Sections 13, 20, 22, and 26b, the German Pfandbrief Act sets volume limits for all types of cover assets with regard to the extension of the preferential right in insolvency to cover assets located in third countries. Pfandbrief cover assets from third countries may be excluded from the limits if substitute legal constructions are implemented that ensure that the third-country cover assets are allocated in the event of the Pfandbrief bank's insolvency. The vdp has had academic reports drawn up that indicate alternative solutions by way of contractual arrangements; lawyers have drawn up contracts on the basis of these reports. For further details, see Stöcker, O. (2013): *Pfandbriefrechtlicher Insolvenzschutz und ausländische Deckungswerte*, Festschrift Rolf Stürner, p. 815 (pp. 821 et seq.). These rules on third-country cover assets under German Pfandbrief law were time and again the basis for reaching a compromise in the Brussels discussions, in that the

The scope for flexibility in this area is also a consequence of principle-based CB harmonisation. If the same requirements had been imposed on cover assets from third countries as on national or EU cover assets, the special provision of Article 7 of the CB Directive would not have been necessary. In other words, identical requirements would lead to the ineligibility of third-country assets as cover assets, which, in turn, would render Article 7 of the CB Directive obsolete.

As such, the legal situation regarding cover assets from third countries can be summarised as follows: The theoretical risk that creditors other than CB creditors might be able to access cover assets located in a third country by means of attachment measures after the opening of insolvency proceedings against the CB issuer cannot be excluded by national or EU legislative measures. Similarly, the opening of secondary of territorial bankruptcy proceedings against the assets of the CB issuer located there cannot be completely ruled out. These risks can be reduced by legal volume restrictions or other measures. In accordance with principle-based harmonisation, the complexity associated with third-country cover assets lies within the competence and area of responsibility of the national CB legislator.

4.5 Segregation of assets before the opening of insolvency proceedings

Sometimes, the requirement is made that the segregation of assets has to be possible at all times. Based on Article 12(2) of the CB Directive[74] alone, one may conclude that the segregation of assets has to exist prior to the opening of insolvency or resolution proceedings, otherwise the inclusion of the word "also" does not make sense.

This seems plausible at first glance. Nevertheless, one can legitimately ask what the purpose of a "segregation of assets" protection mechanism is if a CB issuer is financially sound and liquid.

In addition, Article 12(2) of the CB Directive does not specify what is meant by segregation of assets prior to insolvency proceedings and from that moment on.

A look at point (6) of Article 3 of the CB Directive provides some guidance here: Segregation of assets is defined there as "the actions performed by a credit institution issuing covered bonds to identify cover assets and put them legally beyond the reach of creditors other than covered bond investors." This shows that, in addition to the segregation component, the identification of cover assets is also an

German solution was judged to be balanced and should continue to apply and therefore be compatible with Articles 7 and 12 of the CB Directive.

74 "The segregation of cover assets (…) shall also apply in the case of insolvency or resolution of the credit institution issuing covered bonds."

objective, and this determination can be made prior to a crisis situation (e.g., by entering the assets in a cover register).[75]

A liquid credit institution will settle undisputed liabilities, otherwise it risks facing problems in the interbank and capital markets, where rumours of impending liquidity shortages spread very quickly and can lead to a real problem. Consequently, there should be no attaching creditor who could seize a cover asset. Therefore, there is no need to require the segregation of assets to protect against potential attaching creditors even before a crisis situation arises; the identifiability is fully sufficient, and this is what the CB Directive intends.

Moreover, no national legislator can directly regulate cross-border attachment protection, as attachment protection is part of the enforcement proceedings law, which is governed by *lex fori*. If the separation of assets were to be understood as broadly as this, it would practically rule out the use of EU cross-border assets to cover covered bonds. However, damaging the EU single market is certainly not the aim of CB harmonisation.

4.6 Segregation of assets in resolution proceedings

Article 12(2) of the CB Directive states that the "segregation of cover assets (…) shall also apply in the case of (…) resolution of the credit institution issuing covered bonds." This too shows that asset segregation does not have to mean an irreversible segregation between cover assets and the other assets of a CB issuer, as would be the case from the opening of insolvency proceedings.

Indeed, the objective of resolution may well be recapitalisation by writing down liabilities[76] and thus the full continuation of the credit institution, including its CB component. In this context, the ongoing ability to issue covered bonds could make a decisive contribution to the success of the bank's continuation, as covered bonds provide a better basis for funding than other capital market instruments, especially in times of crisis. Segregation of the cover assets could run counter to this objective, or even thwart it entirely.

75 For the other options, see 3.5 above.

76 Special provisions apply to covered bonds in resolution proceedings. In particular, covered bonds may only be "written down" to the extent that they are not covered by cover assets (in accordance with the fourth sentence of Article 44(2) of the BRRD, transposed into German law in point 2 of Section 91(2) of the SAG).

4.7 Cover pool monitors and public supervision

The provisions of Article 13 of the CB Directive on the "cover pool monitor" and, in particular, of Articles 18 to 26 of the CB Directive on "covered bond public supervision" are groundbreaking, as there has been nothing comparable on covered bonds in EU law until now.[77] Without the intensive work of the EBA, this density of regulation would not have been possible.

It was long disputed whether the function of a responsible individual to monitor cover pools and CB issuances was part of supervision. This is as, in some EU countries, bank supervisory authorities have hardly performed any tasks with respect to covered bonds. Rather, the "supervision" was at times left to cover pool monitors. However, the supervisory authorities did not want to accept responsibility for a cover pool monitor's mistakes in the event that something went wrong. The very fact that Article 13 is located in Title II of the CB Directive, and Articles 18 et seq. are located in Title III of the CB Directive (i.e., in different Titles), shows the decision of the EU legislator that the activity of a cover pool monitor cannot be considered part of public supervision.

It is a subject of discussion whether the cover pool monitor's reporting obligation in accordance with point (d) of Article 13(2) of the CB Regulation means that it has to send unsolicited reports to the competent authorities on a regular basis. However, the precept of principle-based harmonisation applies here as well. Since the manner in which reports are to be submitted is left open here, these details are left to national CB legislators. The reference to Article 18(2) of the CB Directive only indicates to whom the reports have to be submitted, namely the competent authorities designated by EU Member States for the public supervision of CB issuers.

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",[78] as well as of an "internal cover pool monitor"

77 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.

78 First sentence of Article 13(3) of the CB Directive.

[79] when the function is not separate from the credit institution. However, neither the selection criteria nor the economic relationship[80] 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.

The attention to detail with which Articles 18 to 26 of the CB Directive 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 CB Directive 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.

After lengthy discussions, a large majority agreed that EU Member States have a duty to ensure that "the competent authorities (…) have the expertise, resources, operational capacity, powers and independence necessary to carry out the functions relating to covered bond public supervision."[81] Although this sounds self-evident, many countries still have no person in the national competent authorities that is responsible for CB issues (such as the interpretation of CB law), so there is a great deal of organisational work to be done here.

A very important but equally controversial regulatory idea did not gain acceptance either in the EBA's CB working group or in the subsequent EU legislative process; namely the obligation of the competent authorities to regularly review cover assets. Only the duty of national CB legislators to give their competent authorities "the power to carry out on-site and off-site inspections"[82] was included.

4.8 Investor information

The provisions included in Article 14 of the CB Directive have been largely taken from Article 129(7) of the CRR. There is particular discussion of how to transpose the requirement in national CB law that CB issuers have to regularly publish information on credit risks.[83]

Here too, the CB Directive 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.

79 Second sentence of Article 13(3) of the CB Directive.

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

81 Article 18(6) of the CB Directive.

82 Point (c) of Article 22(2) of the CB Directive.

83 Point (d) of Article 14(2) of the CB Directive.

The connection between this provision and Article 6 of the CB Directive 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.

4.9 Coverage requirements

Article 15 of the CB Directive contains provisions on coverage principles[84] and coverage calculation.[85] 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.[86]

For the first time, an EU provision has stipulated that winding-down costs are to be taken into account in the coverage calculation:[87] "the expected costs related to maintenance and administration for the winding-down of the covered bond programme." This is discussed in greater detail below.

a) According to point (20) of Article 3 of the CB Directive, resolution should be understood within the meaning of point (1) of Article 2(1) of the BRRD,[88] which defines this term as: "the application of a resolution tool (…) in order to achieve one or more (…) resolution objectives." As such, resolution does not necessarily mean the opening of insolvency proceedings. Rather resolution can also consist of recapitalising the entire credit institution through writing down liabilities (a bail-in), thereby continuing their business activities,

84 Article 15(2) of the CB Directive.

85 Questions have on occasion arisen regarding the fact that the liabilities to be covered expressly mention CB interest payments in point (b) of Article 15(3) of the CB Directive, however, no mention is made of these with respect to the cover assets contributing to coverage requirements in Article 15(4) of the CB Directive. This does not mean that only principal claims should be included in the cover assets when calculating coverage (especially since these are not explicitly mentioned either). Rather, this discrepancy is explained by the fact that point (4) of Article 3 of the CB Directive defines cover assets as those assets that are included in the cover pool without distinguishing between principal and interest claims.

86 Article 15(6) of the CB Directive. This allows the continuation of the net present value calculation of cover as it is currently regulated in national CB laws (such as in Section 4(1) of the German Pfandbrief Act).

87 Point (d) of Article 15(3) of the CB Directive.

88 The Bank Recovery and Resolution Directive: 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, OJEU L 173/190 of 12 June 2014.

including the CB programme. In such a case, covered bonds and cover assets are usually not separated from the CB issuer. Consequently, this case cannot be used as a basis for the calculation of winding-down costs. Instead, the focus should be on cases of insolvency, which are likely to represent the maximum cost volume. If the resolution authorities were then to decide on a less costly winding-down variant for the CB part of a CB programme, the financial reserves for the costs then incurred would be all the more sufficient.

Point (2) of Article 3 of the CB Directive defines a covered bond programme as "the structural features of a covered bonds issue that are determined by statutory rules and by contractual terms and conditions, in accordance with the permission granted to the credit institution issuing the covered bonds." In simple terms, this refers to the totality of the covered bonds and the related cover assets; as CB models can vary widely, this somewhat complicated description was chosen to ensure that all CB models are covered. Furthermore, the term "programme" is commonly used by market participants to describe this totality.

b) As the coverage requirements have to be complied with "at all times",[89] this means that the coverage calculation has to be carried out on each and every bank business day. However, 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".[90]

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 lumps 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.[91] 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 CB Directive and Article 129 of the CRR). Rather, the entirety of the liabilities referred to in Article 15(3) of the CB Directive, including the

89 Article 15(1) of the CB Directive.

90 Second sentence of Article 15(3) of the CB Directive.

91 See 5 below.

winding-down costs, forms the basis of the calculation of the statutory overcollateralisation requirements of Article 129 of the CRR;[92] the winding-down costs consequently increase the calculation basis for the statutory fulfilment of the overcollateralisation requirements. This is particularly clear from the definition set out in point (14) of Article 3 of the CB Directive, according to which "'overcollateralisation' means the entirety of the statutory, contractual or voluntary level of collateral that exceeds the coverage requirement set out in Article 15," of which the winding-down costs form an integral component.

c) With respect to point d) of Article 15(3) and Article 15(4) of the CB Directive, the question of whether this inclusion of winding-down costs in the coverage calculation needs to be fulfilled after the opening of insolvency proceedings against a CB issuer has already been discussed on several occasions. Since the aim of the provision is to cover precisely these costs, it is not possible to save the funds for later when they are currently needed in the event of insolvency.

   This can be different in resolution proceedings. If the resolution authority chooses to allow the credit institution to continue, including the CB component, the winding-down costs have to be fully included in the cover calculation, as a later case of insolvency cannot be excluded.

4.10 Requirement for a cover pool liquidity buffer

Article 16 of the CB Directive 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.

92 In contrast, the statutory overcollateralisation of 2 percent of net present value provided in Section 4(1) of the German Pfandbrief Act 2005 was taken over from the German Mortgage Bank Act, where it had only been regulated since 2004, in order to cover, among other things, the costs of managing the cover pool in the case of a Pfandbrief bank becoming insolvent. The winding-down costs were therefore not yet part of coverage calculation to cover the liabilities and consequently do not increase the cover basis of the statutory overcollateralisation.

a) There were intense discussions on how Article 16 of the CB Directive could be brought into line with the LCR requirements[93] of general banking supervision law,[94] which lay down criteria for the eligibility of covered bonds as "liquid assets".[95]

Taken on its own, Article 16 would mean that CB issuers would have to comply with the provisions of two legal acts, both aiming at the same objective – namely, to maintain a liquidity buffer for payment obligations for the next 30 days. The CB liquidity buffer requires this for all CB liabilities, and for a period of time as long as 180 days. The LCR provisions require this for all liabilities of the CB issuer (and thus also for the CB liabilities) for the next 30 days. The overlap for the first 30 days results in a double burden for CB issuers.

However, until the adoption of the CB Directive, no agreement could be reached on how to avoid this double burden. In addition, the required amendment to the LCR Delegated Regulation to eliminate the double burden was not possible in parallel with the creation of the CB Directive.

As a compromise, an interim solution was arrived at, resulting in the provision in Article 16(4) of the CB Directive. Although difficult to understand at first glance, the provision aims to avoid this double burden on CB issuers. According to the provision, national CB legislators may, on a transitional basis, allow the first 30 days of the 180-day liquidity buffer to be covered only by the LCR.[96] This applies until such time as the double burden is eliminated by an amendment to the LCR provisions[97] (work is already underway to amend the LCR Delegated Regulation to eliminate this double burden).[98]

93 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.

94 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. For more on this provision and the associated delegated regulation, see Boos, K.-H. – Fischer, R. – Schulte-Mattler, H. [eds.] (2016): KWG, CRR-VO, 5th Ed., Munich 2016, Art. 412 CRR, marginal notes 1 et seq.

95 For more on the LCR with respect to covered bonds, see Will, F. (2019): 2.2 Regulatory Issues, 2.2.1 Covered bonds and EU banking regulations. In European Covered Bond Fact Book 2019, Munich: ECBC, p. 164 et seq.

96 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.

97 As the LCR provisions require all liabilities of a CB issuer to be considered, a solution has to be anchored in the LCR legislation.

98 Even during the work on the CB Directive, 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.

b) Article 16(5) of the CB Directive simplifies matter 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 are postponed by at least this period.[99]

4.11 Conditions for extendable maturity structures

For a number of years now, more and more CB issuers throughout Europe have been providing in their terms and conditions of issuance that the maturity of their covered bonds may be extended under certain conditions.[100] Given the major significance of this development, it was necessary to include the topic in the CB Directive.

Article 17 of the CB Directive 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,[101] or limit themselves to the basic principles and leave further design to the CB issuers.

4.12 The following topics continue to be the focus of in-depth discussions:

a) 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).[102] These maturity extension triggers are to be specified in the contractual terms and conditions of the covered bond.[103] When introducing

99 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. For more on this, see 4.11.

100 For an overview of this topic, see Rudolf, F. (2019): Extendable maturity structures – the new standard. In European Covered Bond Fact Book 2019, Munich: ECBC, p. 85 et seq.

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

102 Point (a) of Article 17(1) of the CB Directive.

103 Point (b) of Article 17(1) of the CB Directive.

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 CB Directive 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 CB Directive.[104]

b) The final maturity date of a covered bond with an extendable maturity structure is to be determinable at all times.[105] However, this provision does not stipulate that this determination needs to be possible for every person.

The term "determinable" was deliberately chosen, as opposed to, for example, "specified". As such, the CB Directive grants a great deal of scope with respect to design. It also allows for covered bonds with conditional pass-through structures,[106] which (as usual) include a legal final maturity in their terms and conditions of issuance, on the basis of which a calculation can be made. It should also be emphasised that Article 16(5) of the CB Directive allows the liquidity buffer to be based on the final maturity date, which applies to all forms of maturity extension.[107]

c) 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.[108] 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 CB Directive does not intend to interfere with the basic structure of CB systems. As such, this provision should be narrowly interpreted

---

104 However, without the additional label of "European" (and definitely not of "Premium") that results from the interaction of Articles 27 and 30 of the CB Directive.

105 Point (d) of Article 17(1) of the CB Directive.

106 For more on this, see Rudolf, F. (2019): Extendable maturity structures – the new standard. In European Covered Bond Fact Book 2019, Munich: ECBC,, p. 85 (p. 86).

107 See III. 8. b) above.

108 Point (e) of Article 17(1) of the CB Directive.

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.

Thus, if national CB law allows an administrator of cover pools and covered bonds to generally change the order in which they are serviced (i.e., without extending the maturity), they should be able to do so in addition to extending the maturity date. The main options here are: repurchasing covered bonds,[109] exercising call options,[110] taking out loans and thus creating new liabilities, and the issuance of new covered bonds.

In this context, it should be noted that "ranking of covered bond investors" refers to the situation where payments are not sufficient for all creditors, and that "sequencing of the covered bond programme's original maturity schedule" is used when referring to the timing and sequence of payments.

d) Recital 33 of the CB Directive, which enables national CB legislators to grant national CB competent authorities the power "to invalidate a maturity extension", is more difficult to comprehend. It seems hard to envisage in the case of maturity extensions that have already been implemented. It is more conceivable that this could be prescribed prior to an extension in order to prevent it. Apparently, the EU legislator was not entirely comfortable with this topic either, as it is not provided for in Article 17 of the CB Directive.[111]

4.13 Labelling

Article 27 of the CB Directive 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 CB Directive 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.

109 For example, repurchasing below the nominal value in order to increase overcollateralisation.

110 This can be considered, for example, if the outstanding covered bonds have very different interest rates and the administrator wants to service the high-yield covered bonds earlier than the low-yield covered bonds.

111 This was possibly one of the disputed provisions that could not be pushed through, but it was forgotten to delete the recital drafted for it.

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 CB Directive.

4.14 Transitional measures

The grandfathering provision of Article 30(1) of the CB Directive permits covered bonds issued until 8 July 2022 to be designated as covered bonds in accordance with the CB Directive, even if they do not meet the requirements of various expressly mentioned provisions[112] of the CB Directive.[113] However, the terms "European" and "Premium" may not be used for such covered bonds.

5. 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 CB Directive.[114]

In accordance with the first sentence of Article 129(3a) of the CRR, the minimum level of overcollateralisation is to be 5 percent.[115] 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 percent.

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";[116] such a reduction must therefore be risk-adjusted.

112 Articles 5–12, 15, 16, 17 and 19 of the CB Directive.

113 For the application of Article 30 of the CB Directive when a statutory provision introduces an extension of maturity without (subsequent) changes in the terms and conditions of issuance, see 4.12 a) above.

114 For more on this, see 4.9 b) above.

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

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

6 EUROPEAN COMMISSION AND EBA TASKS

Through Article 31 of the CB Directive, 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[117] for the regulatory treatment of covered bonds issued by third-country credit institutions;[118]
- 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;[119]
- By 8 July 2024: The commissioning of a study on the risks and benefit arising from covered bonds with extendable maturity structures;[120]
- By 8 July 2024: The adoption of a report on the possibility of introducing a dual-recourse instrument named a European Secured Note (ESN).[121]

7 OUTLOOK

The CB harmonisation package is to be warmly welcomed as an important milestone in the development of CB legislation. Principle-based harmonisation allows national CB legislators enough room to maintain and individually develop the legal structures of their CB models, while also achieving an EU-wide minimum standard, which will certainly have spill-over effects beyond the EU on other CB systems. Despite criticisms that provisions are unclear, too far reaching, or not far-reaching enough, it should be noted that this European Union CB legislative

117 Consideration could be given to requiring mutual recognition of the preferential treatment of CB creditors in order to solve the legal problem described in 4.4. Possible formulations could be based on the CB laws in Germany, Ireland, Luxembourg, and Austria from the 1990s. These countries included such provisions in the CB laws until the creation of the Directive on the Reorganisation and Winding-up of Credit Institutions. With these laws, these four countries achieved complete protection of the foreign cover assets among themselves in favour of the respective CB creditors with regard to the allocation of these cover assets.

118 Article 31(1) of the CB Directive. The proposal to include an equivalence provision in the CB Directive as early as 2019 was not accepted.

119 Article 31(2) of the CB Directive.

120 Article 31(4) of the CB Directive.

121 Article 31(5) of the CB Directive.

package has laid the foundation for ensuring that covered bonds will continue to remain deeply anchored in the EU regulatory framework.

As early as 2019, the European Commission announced that it would discuss questions of interpretation in a special group of experts, which – just like the Council working group during the EU legislative process – would include representatives of national governments and supervisory authorities. It was originally planned that this interpretation working group could meet as early as spring 2020. However, as most national legislators did not want to start their deliberations on transposition until the European Union CB harmonisation package had been published in *The Official Journal of the European Union*, the project was postponed. Due to personnel changes in the European Commission and the COVID-19 pandemic, the timetable was changed again, so that the meeting of the interpretation working group is now expected in the autumn of 2020 at the earliest.

Work on the timely transposition of the CB harmonisation package into German law began in parallel with the final editing of the work at the EU level. It can be expected that the German Federal Ministry of Finance (Bundesministerium der Finanzen) will initiate the parliamentary procedure to amend the German Pfandbrief Act in autumn 2020.