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'I' ITEM NOTE

From:	General Secretariat of the Council
To:	Permanent Representatives Committee
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Subject:	Proposal for a REGULATION OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL on amending Regulation (EU) No 575/2013 as regards exposures in the form of covered bonds - Mandate for negotiations with the European Parliament = Compromise proposal

Proposal for a

REGULATION OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL

on amending Regulation (EU) No 575/2013 as regards exposures in the form of covered bonds

(Text with EEA relevance)

THE EUROPEAN PARLIAMENT AND THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty on the Functioning of the European Union, and in particular Article 114 thereof,

Having regard to the proposal from the European Commission,

After transmission of the draft legislative act to the national parliaments,

Having regard to the opinion of the European Central Bank¹,

Having regard to the opinion of the European Economic and Social Committee²,

Acting in accordance with the ordinary legislative procedure,

¹ OJ C [...], [...], p. [...].

² OJ C [...], [...], p. [...].

Whereas:

- (1) Article 129 of Regulation (EU) No 575/2013 of the European Parliament and of the Council³ grants, under certain conditions, preferential treatment to covered bonds. Directive (EU) 20xx/xx [OP: Please insert reference to Directive (EU) 20xx/xx on the issue of covered bonds and covered bond public supervision and amending Directive 2009/65/EU and Directive 2014/59/EU] specifies the core elements of covered bonds and provides for a common definition of covered bonds.
- (2) On 20 December 2013 the Commission issued a call for advice to the European Banking Authority (EBA) regarding the appropriateness of the risk weights set out in Article 129 of Regulation (EU) No 575/2013. According to EBA's opinion,⁴ the preferential risk weight treatment laid down in Article 129 of that Regulation is, in principle, an appropriate prudential treatment. However, EBA recommended that further consideration be given to the opportunity of complementing the eligibility requirements as set out by Article 129 of Regulation (EU) No 575/2013 to cover, at a minimum, the areas of liquidity risk mitigation, over-collateralisation, the role of the competent authority, and the further elaboration of existing requirements on disclosure to investors⁵.
- (3) In light of the EBA's opinion, it is appropriate to amend Regulation (EU) No 575/2013 by adding additional requirements for covered bonds, thereby strengthening the quality of covered bonds eligible for favourable capital treatment as provided for in Article 129 of that Regulation.

³ 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 (OJ L 176, 27.6.2013, p. 1).

⁴ Opinion of the European Banking Authority on the preferential capital treatment of covered bonds, EBA/Op/2014/04.

⁵ Recommendations EU COM 1-A to 1-D set out in Opinion EBA/Op/2014/04.

- (4) Pursuant to the third subparagraph of Article 129(1) of Regulation (EU) No 575/2013, competent authorities may partially waive the application of the requirement for exposures to qualify for credit quality step 1, as laid down in point (c) of the first subparagraph of Article 129(1), and allow an exposure which qualifies for credit quality step 2 up to a maximum of 10% of the total exposure of the nominal amount of outstanding covered bonds of the issuing institution. Such a partial waiver however applies only after prior consultation with the EBA and only provided that significant potential concentration problems in the Member States concerned can be documented as a result of the application of the credit quality step 1 requirement. As the requirements for exposures to qualify for credit quality step 1 as made available by External Credit Assessment Institutions have become increasingly difficult to comply with in most Member States both within and outside the euro zone, the application of that waiver was considered necessary by those Member States which host the largest covered bonds markets. To simplify the use of exposures to credit institutions as collateral for covered bonds and in order to address that difficulty, it is necessary to amend Article 129(1) of Regulation (EU) No 575/2013. Instead of a possibility for the competent authorities to waive the requirements, it is appropriate to establish a rule allowing exposures to credit institutions which qualify for credit quality step 2 up to a maximum of 10% of the total exposure of the nominal amount of outstanding covered bonds of the issuing institution without the need to consult the EBA. It is necessary to accommodate for the use of derivatives in specific Member States in cases where complying with the requirement for credit quality step 1 or 2 would be too difficult. Competent authorities designated pursuant to Article 18(2) of Directive (EU) 20... [OP: Please insert reference to Directive (EU) on the issue of covered bonds and covered bond public supervision and amending Directive 2009/65/EC and Directive 2014/59/EU] may, after having consulted the EBA, allow the use of credit quality step 3 for derivative counterparts in order to address potential concentration problems.

- (5) In accordance with points (d)(ii) and (f)(ii) of the first subparagraph of Article 129(1) of Regulation (EU) No 575/2013, loans secured by senior units issued by French *Fonds Communs de Titrisation* or equivalent securitisation entities securitising residential or commercial property exposures are eligible assets which can be used as collateral for covered bonds up to a maximum of 10 % of the nominal amount of the outstanding issue of covered bonds (the '10 % threshold'). However, Article 496 of that Regulation allows competent authorities to waive the 10% threshold. Furthermore, Article 503(4) of the same Regulation requires the Commission to review the appropriateness of the derogation allowing competent authorities to waive the 10 % threshold. On 22 December 2013, the Commission requested the EBA to provide an opinion in that regard. On 1 July 2014, the EBA stated that the use of senior units issued by French *Fonds Communs de Titrisation* or equivalent securitisation entities securitising residential or commercial property exposures as collateral would cause prudential concerns due to the double layer structure of a covered bond programme backed by securitisation units and thereby would lead to insufficient transparency regarding the credit quality of the cover pool. Consequently, the EBA recommended that the derogation from the 10 % threshold for senior securitisation units currently laid down in Article 496 of Regulation (EU) No 575/2013 be removed after 31 December 2017⁶.
- (6) Only a limited number of national covered bond frameworks allow the inclusion of residential or commercial mortgage-backed securities. The use of such structures is decreasing and is considered to add unnecessary complexity to the covered bond programmes. It is thus appropriate to eliminate the use of such structures as eligible assets altogether. Therefore points (d)(ii) and (f)(ii) of the first subparagraph of Article 129(1) of Regulation (EU) No 575/2013, as well as Article 496 of that Regulation should be deleted.

⁶ Recommendation EU COM 2 set out in Opinion EBA/Op/2014/04.

- (7) Intragroup pooled covered bond structures which comply with Regulation (EU) No 575/2013, have also been used as eligible collateral in accordance with points (d)(ii) and (f)(ii) of the first subparagraph of Article 129(1) of that Regulation. Intragroup pooled covered bond structures do not pose additional risks from a prudential perspective because they are not raising the same complexity issues as the use of loans secured by senior units issued by French *Fonds Communs de Titrisation* or equivalent securitisation entities securitising residential or commercial property exposures. According to the EBA, collateralisation of covered bonds by pooled covered bond structures should be allowed without limits related to the amount of outstanding covered bonds of the issuing credit institution⁷. Accordingly, point (c) of the first subparagraph of Article 129(1) should be amended to remove the requirement to apply the limit of 15 % or 10 % in relation to exposures to credit institutions in intragroup pooled covered bond structures. Those intragroup pooled covered bond structures are regulated by Article 8 of Directive (EU) 20.../.... [OP: Please insert reference to Directive (EU) on the issue of covered bonds and covered bond public supervision and amending Directive 2009/65/EC and Directive 2014/59/EU].
- (8) Article 129(3) of Regulation (EU) No 575/2013 requires that the valuation principles for immovable property collateralising covered bonds, set out in Article 229(1) of that Regulation, be applied to covered bonds in order for those bonds to meet the requirements for preferential treatment. The requirements for the eligibility of assets serving as collateral for covered bonds relate to the general quality features ensuring the robustness of the cover pool and should therefore be subject to Directive (EU) 20.../... [OP: Please insert reference to Directive (EU) on the issue of covered bonds and covered bond public supervision and amending Directive 2009/65/EC and Directive 2014/59/EU]. Accordingly, the provisions on valuation methodology should also be subject to that Directive. The regulatory technical standards mandated by Article 124(4)(a) of Regulation (EU) No 575/2013 should therefore not apply in respect of the eligibility criteria for covered bonds as set out in Article 129 of that Regulation. It is therefore necessary to amend Article 129(3) of that Regulation to that effect.

⁷ *Ibid.*

- (9) Limits for Loan-To-Value ('LTV') are a necessary part of ensuring the credit quality of the covered bonds. Article 129(1) of Regulation (EU) No 575/2013 establishes the LTV limits for mortgage and ship assets but does not specify how those limits are to be applied which may lead to uncertainty. The LTV limits should be applied as soft coverage limits, meaning that while there are no limits to the size of an underlying loan, such a loan can only act as collateral within the LTV limits imposed on the assets. The LTV limits determine the percentage portion of the loan that contributes to the coverage requirement for coverage of the liabilities. It is therefore appropriate to specify that the LTV limits apply to the portion of the loan contributing to the coverage of the covered bond.
- (10) To ensure greater clarity, it should also be specified that the LTV limits are applicable throughout the entire maturity of the loan. The actual LTV should not change but remain at the limit of 80% of the value of the property for residential loans, and at the limit of 60% of the value of the property for commercial loans and ships.
- (11) In order to further enhance the quality of the covered bonds that receive the preferential capital treatment as provided for in Article 129 of Regulation (EU) No 575/2013, that preferential treatment should be subject to a minimum level of overcollateralisation, meaning a level of collateral exceeding the coverage requirements as referred to in Article 15 of Directive (EU) 20.../... [OP: Please insert reference to Directive (EU) on the issue of covered bonds and covered bond public supervision and amending Directive 2009/65/EC and Directive 2014/59/EU]. Such a requirement serves the purpose of mitigating the most relevant risks arising in case of the issuer's insolvency or resolution.

- (12) One of the requirements laid down in Article 129(7) of Regulation (EU) No 575/2013 is that the credit institution investing in covered bonds receives certain information on the covered bonds on at least a semi-annual basis. Transparency requirements are an indispensable part of covered bonds ensuring a uniform disclosure level and allowing investors to perform the necessary risk assessment, enhancing comparability, transparency and market stability. Therefore, it is appropriate to ensure that transparency requirements apply to all covered bonds which can be achieved by laying down those requirements in Directive (EU) 20.../... [OP: Please insert reference to Directive (EU) on the issue of covered bonds and covered bond public supervision and amending Directive 2009/65/EC and Directive 2014/59/EU] as common structural feature of covered bonds. Accordingly, Article 129(7) of Regulation (EU) No 575/2013 should be deleted.
- (13) Covered bonds are long-term funding instruments and therefore issued with a scheduled maturity of several years. It is therefore necessary to ensure that covered bonds issued before 31 December 2007 or before [OP: Please insert the date of application of this Regulation] are not disrupted. In order to achieve that objective, covered bonds issued before 31 December 2007 should remain exempted from the requirements set out in Regulation (EU) No 575/2013 with respect to eligible assets, overcollateralisation and substitution assets. In addition, other covered bonds complying with Regulation (EU) No 575/2013 and issued before [OP: Please insert the date of application of this Regulation] should be exempted from the requirements on overcollateralisation and substitution assets and should continue to be eligible for the preferential treatment as set out in that Regulation until their maturity.

- (14) This Regulation should be applied in conjunction with [OP: Please insert reference to Directive (EU) on the issue of covered bonds and covered bond public supervision and amending Directive 2009/65/EC and Directive 2014/59/EU]. In order to ensure the consistent application of the new framework establishing the structural features of the issue of covered bonds and the amended requirements for preferential treatment, the application of this Regulation should be deferred to coincide with the date from which Member States are to apply the provisions transposing that Directive.
- (15) Regulation (EU) No 575/2013 should therefore be amended accordingly.

HAVE ADOPTED THIS REGULATION:

Article 1

Amendments to Regulation (EU) No 575/2013

Regulation (EU) No 575/2013 is amended as follows:

1. Article 129 is amended as follows:

(a) paragraph 1 is amended as follows:

(i) the first subparagraph is amended as follows:

— the introductory phrase is replaced by the following:

"To be eligible for the preferential treatment set out in paragraphs 4 and 5, covered bonds, as referred to in Article 2 of Directive (EU) 20xx/xxxx of the European Parliament and of the Council*[OP: Please insert reference to Directive (EU) on the issue of covered bonds and covered bond public supervision and amending Directive 2009/65/EC and Directive 2014/59/EU], shall meet the requirements set out in paragraphs 3, 3a and 3b of this Article and shall be collateralised by any of the following eligible assets:"

* [OP, please insert a reference to Directive (EU) 20xx/xx of the European Parliament and of the Council on the issue of covered bonds and covered bond public supervision and amending Directive 2009/65/EU and Directive 2014/59/EU (OJ C [...], [...], p. [...])].";

— point (c) is replaced by the following:

"(c) exposures to credit institutions that qualify for credit quality step 1, credit quality step 2 or exposures in the form of short-term deposits where used to fulfil the cover pool liquidity buffer requirement in Article 16 and derivative contracts in accordance with Article 11 of Directive (EU) 20.../... [OP: Please insert reference to Directive (EU) on the issue of covered bonds and covered bond public supervision and amending Directive 2009/65/EC and Directive 2014/59/EU] to credit institutions that qualify for credit quality step 3, where exposures in the form of derivative contracts are permitted by the competent authorities, as set out in this Chapter.";

— in point (d), point (ii) is deleted;

— in point (f), point (ii) is deleted;

(ii) the second subparagraph is replaced by the following:

"For the purposes of paragraph 1a, exposures caused by transmission and management of payments of the obligors of, or liquidation proceeds in respect of, loans secured by pledged properties debt securities shall not be comprised in calculating the limits referred to in this point.";

(iii) the third subparagraph is deleted;

(b) the following paragraphs 1a, 1b and 1c are inserted:

"1a. For the purposes of point (c) of the first subparagraph of paragraph 1, the following shall apply:

(a) for exposures to credit institutions that qualify for credit quality step 1 the exposure shall not exceed 15 % of the nominal amount of outstanding covered bonds of the issuing credit institution;

- (b) for exposures to credit institutions that qualify for credit quality step 2 the exposure shall not exceed 10 % of the total exposure of the nominal amount of outstanding covered bonds of the issuing credit institution;
- (b1) for exposures in the form of short-term deposits and derivative contracts to credit institutions that qualify for credit quality step 3, the exposures shall not exceed 10 % of the total exposure of the nominal amount of outstanding covered bonds of the issuing credit institution;

The competent authorities designated pursuant to Article 18(2) of Directive (EU) 20xx/xxxx [OP: Please insert reference to Directive (EU) on the issue of covered bonds and covered bond public supervision and amending Directive 2009/65/EC and Directive 2014/59/EU] may, after having consulted the EBA, allow exposures in the form of derivative contracts to credit institutions that qualify for credit quality step 3 only where significant potential concentration problems in the Member States concerned due to the application of credit quality step 1 and credit quality step 2 requirements referred to in this paragraph can be documented.

- (c) the total exposures to credit institutions that qualify for credit quality step 1, credit quality step 2 or credit quality step 3 shall not exceed 15 % of the total exposure of the nominal amount of outstanding covered bonds of the issuing credit institution. The total exposures to credit institutions that qualify for credit quality step 2 or credit quality step 3 shall not exceed 10% of the total exposure of the nominal amount of outstanding covered bonds of the issuing credit institution.

This paragraph shall not apply to the use of covered bonds as eligible collateral as permitted pursuant to Article 8 of Directive (EU) 20xx/xxxx [OP: Please insert reference to Directive (EU) on the issue of covered bonds and covered bond public supervision and amending Directive 2009/65/EC and Directive 2014/59/EU].

- 1b. For the purposes of point (d)(i) of the first subparagraph of paragraph 1, the limit of 80 % shall refer to the portion of the loan contributing to the coverage of liabilities attached to the covered bond and be applicable throughout the entire maturity of the loan.
- 1c. For the purposes of point (f)(i) and point (g) of the first subparagraph of paragraph 1, the limit of 60 % or 70 %, respectively shall refer to the portion of the loan contributing to the coverage of liabilities attached to the covered bond and be applicable throughout the entire maturity of the loan.";
- (c) paragraph 3 is replaced by the following:
- "3. For immovable property collateralising covered bonds compliant with this Regulation, the requirements set out in Article 208 shall be met.";

(d) the following paragraphs 3a and 3b are inserted:

"3a. In addition to being collateralised by the eligible assets listed in paragraph 1, covered bonds shall be subject to a minimum level of 5 % of overcollateralisation as defined in Article 3(12) of Directive (EU) 20xx/xxx [OP: Please insert reference to Directive (EU) on the issue of covered bonds and covered bond public supervision and amending Directive 2009/65/EC and Directive 2014/59/EU].

For the purposes of the first subparagraph, the total nominal amount of all assets in the cover pool shall be at least of the same value as the total nominal amount of outstanding covered bonds ('nominal principle') and consist of eligible assets as set out in paragraph 1.

The assets contributing to a minimum level of overcollateralisation shall not be subject to the limits on exposure size as set out in paragraph 1a and shall not count towards those limits.

Member States may apply a lower minimum level of overcollateralisation to covered bonds provided that the following conditions are met:

- (a) the calculation of overcollateralisation is either based on an approach which takes into account the underlying risk of the assets or an approach where the valuation of the assets is subject to mortgage lending value as defined in Article 4(1)(74);
- (b) the minimum level of overcollateralisation cannot be lower than 2 % based on the nominal principle.

3b. Eligible assets referred to in paragraph 1 may be included in the cover pool as substitution assets as defined in Article 3(11) of Directive (EU) 20xx/xxx [OP: Please insert reference to Directive (EU) on the issue of covered bonds and covered bond public supervision and amending Directive 2009/65/EC and Directive 2014/59/EU] for the primary assets as defined in Article 3(10) of that Directive, subject to the limits on credit quality and exposure size as set out in paragraphs 1 and 1a of this Article.";

(e) paragraphs 6 and 7 are replaced by the following:

"6. Covered bonds issued before 31 December 2007 shall not be subject to the requirements of paragraphs 1, 3, 3a and 3b. They shall be eligible for the preferential treatment under paragraphs 4 and 5 until their maturity.

7. Covered bonds issued before [OP please insert the date of application of this amending Regulation] and complying with the requirements laid down in this Regulation, in the version applicable on the date of their issue, shall not be subject to the requirements of paragraphs 3a and 3b. They shall be eligible for the preferential treatment under paragraphs 4 and 5 until their maturity."

(2) in point (a) of Article 416(2), point (ii) is replaced by the following:

"(ii) they are bonds as referred to in Article 2 of Directive (EU) 20xx/xxxx [OP: Please insert reference to Directive (EU) on the issue of covered bonds and covered bond public supervision and amending Directive 2009/65/EU and Directive 2014/59/EU] other than those referred to in point (i) of this point;"

(3) in Article 425, the first paragraph is replaced by the following:

"1. Institutions shall report their liquidity inflows. Capped liquidity inflows shall be the liquidity inflows limited to 75 % of liquidity outflows. Institutions may exempt liquidity inflows from deposits placed with other institutions and qualifying for the treatments set out in Article 113(6) or (7) from this limit. Institutions may exempt liquidity inflows from monies due from borrowers and bond investors related to mortgage lending funded by bonds eligible for the treatment set out in Article 129(4), (5) or (6) or by covered bonds as referred to in Article 2 of Directive (EU) 20xx/xxxx [OP: Please insert reference to Directive (EU) on the issue of covered bonds and covered bond public supervision and amending Directive 2009/65/EU and Directive 2014/59/EU] from this limit. Institutions may exempt inflows from promotional loans that the institutions have passed through. Subject to the prior approval of the competent authority responsible for supervision on an individual basis, the institution may fully or partially exempt inflows where the provider is a parent or a subsidiary institution of the institution or another subsidiary of the same parent institution or linked to the institution by a relationship within the meaning of Article 12(1) of Directive 83/349/EEC.";

(4) in point (b) of Article 427(1), point (x) is replaced by the following:

"(x) liabilities resulting from securities issued qualifying for the treatment set out in Article 129(4) or (5) or as referred to in Article 2 of Directive (EU) 20xx/xxxx [OP: Please insert reference to Directive (EU) on the issue of covered bonds and covered bond public supervision and amending Directive 2009/65/EU and Directive 2014/59/EU];";

(5) in point (h) of Article 428(1), point (iii) is replaced by the following:

"(iii) match funded (pass-through) via bonds eligible for the treatment set out in Article 129(4) or (5) or via bonds as referred to in Article 2 of Directive (EU) 20xx/xxxx [OP: Please insert reference to Directive (EU) on the issue of covered bonds and covered bond public supervision amending Directive 2009/65/EU and Directive 2014/59/EU];";

(6) Article 496 is deleted;

(7) in point 6 of ANNEX III, point (c) is replaced by the following:

"(c) they are covered bonds as referred to in Article 2 of Directive (EU) 20xx/xxxx[OP: Please insert reference to Directive (EU) on the issue of covered bonds and covered bond public supervision and amending Directive 2009/65/EU and Directive 2014/59/EU] other than those referred to in point (b) of this point.".

Article 2

Entry into force and application

This Regulation shall enter into force on the twentieth day following that of its publication in the *Official Journal of the European Union*.

It shall apply from [OP: please insert the date laid down in the second subparagraph of Article 32(1) of Directive (EU) 20../... [OP: Please insert reference to Directive (EU) on the issue of covered bonds and covered bond public supervision and amending Directive 2009/65/EC and Directive 2014/59/EU]].

This Regulation shall be binding in its entirety and directly applicable in all Member States.

Done at Brussels,

For the European Parliament

For the Council

The President

The President