

INCEPTION IMPACT ASSESSMENT			
TITLE OF THE INITIATIVE	Initiative on an integrated covered bond framework		
LEAD DG – RESPONSIBLE UNIT	DG FISMA UNIT D.2	DATE OF ROADMAP	09/06/2017
LIKELY TYPE OF INITIATIVE	Directive		
INDICATIVE PLANNING	Q1 2018		
ADDITIONAL INFORMATION	<p>This Inception Impact Assessment aims to inform stakeholders about the Commission's work in order to allow them to provide feedback on the intended initiative and to participate effectively in future consultation activities. Stakeholders are in particular invited to provide views on the Commission's understanding of the problem and possible solutions and to make available any relevant information that they may have, including on possible impacts of the different options. The Inception Impact Assessment is provided for information purposes only and its content may change. This Inception Impact Assessment does not prejudice the final decision of the Commission on whether this initiative will be pursued or on its final content.</p>		

A. Context, Problem definition and Subsidiarity Check
<p>Context</p> <p>Covered bonds are debt securities issued by a credit institution and collateralised against a pool of assets that can cover claims at any point in time. Covered bonds are considered very secure and are a key long-term funding instrument in the EU economy.</p> <p>The initiative to promote greater integration in EU covered bond markets falls under the scope of the Capital Markets Union (CMU) project. As part of the CMU mid-term review adopted by the Commission on 7 June 2017, the Commission announced the adoption in Q1 2018 of a legislative proposal for an EU-framework for covered bonds. In the last year, following the closing of the public consultation on covered bonds in January 2016, which already cautiously supported EU legislative harmonisation in the field, views have further converged on the merits of EU legislative action. Supervisors' views also converged in advocating legislative action at EU level, as evidenced by the European Banking Authority (EBA) Report on Covered Bonds of December 2016. The European Central Bank (ECB) also supports harmonisation for covered bonds. Finally, the European Parliament will present an own initiative report on covered bonds in June 2017.</p>
<p>Problem the initiative aims to tackle</p> <p>Covered bonds have been a resilient source of funding even during the financial crisis. Nevertheless, the Public consultation in 2016, the ICF study and the EBA Report on Covered Bonds of December 2016, all identified significant potential risks and vulnerabilities in the market which could suggest that previous good performance is not necessarily a guarantee of future robustness of the market.</p> <p>First of all, while a favourable legislation is in place at EU level in terms of preferential treatment (UCITS: Undertakings for the Collective Investment of Transferable Securities Directive; CRR: Capital Requirements Regulation; LCR: Liquidity Coverage Ratio Delegated Regulation; BRRD: Bank Recovery and Resolution Directive; Solvency II), covered bonds are regulated at national level and the national regimes vary a great deal.</p> <p>In addition, in the last years, changes have been observed in relation to certain characteristics of the covered bonds (for example in terms of extendable maturities: soft bullet and CPT programmes that aim to mitigate liquidity risk through the introduction of long-term maturity extensions regarding repayments to bondholders). It needs to be assessed whether the risk characteristics of these new structures are aligned with the EU preferential treatment.</p> <p>Finally, while covered bond funding did not suffer during the financial crisis, it could be argued that this strong performance was at least partly due to the exceptional support granted to the banking sector during the crisis. In a new regulatory context that significantly limits the scope of such support and characterised by diverging national regulatory frameworks and market practices, covered bonds may behave differently. The considerable size of the covered bond market and the importance for bank funding combined with regulation by national legislation resulting in very different regimes can put the financial stability at risk. The outstanding volume of covered bonds reached €2.1 trillion in the EU in 2015. Within the EU, Germany is the largest market in terms of outstanding volume (384 bn EUR), followed by Denmark (383 bn EUR), France (323 bn EUR), Spain (281 bn EUR), Sweden (222 bn EUR), Italy (131 bn EUR) and the UK (121 bn EUR). The four largest markets still account for almost two-thirds of the EU market in 2015 (vs. 97% in 2003). Covered bonds are mainly used to refinance mortgages (> 80%) and, to a lesser extent, other asset classes (public sector loans, infrastructure, shipping loans, SME loans</p>

etc.). Covered bonds cover an average of 30% of residential mortgages lending in the EU in 2015 with a certain degree of variability across countries.

Subsidiarity check (and legal basis)

The legal action falls under the competence of the EU according to Art. 114 of the Treaty of Functioning of the European Union (TFEU).

National covered bonds regimes vary significantly, e.g. in terms of public supervision, disclosure, liquidity requirements, composition of the cover pool. In light of these differences, comprehensive action at EU level is recommended under a prudential perspective in order to justify maintaining the favourable prudential treatment at EU level. For example, the increasing use of new structures such as Soft-bullet and Conditional Pass Through (CPT) programmes that aim to mitigate liquidity risk through the introduction of long-term maturity extensions regarding repayments to bondholders, raises the issue of whether the risk characteristics of these new structures are aligned with the EU preferential treatment. Soft bullet/CPT-structures are predominantly a contractual feature.

Only some jurisdictions provide rules in their legislation (Denmark and Poland, while in Germany an industry proposal has recently been submitted). Currently, this process is not under EU control as the UCITS definition is not able to capture these aspects of maturity extension. Harmonizing national frameworks would make sure that the preferential treatment envisaged in EU legislation is actually aligned with the level of risk implied by the EU prudential treatment. The [Public consultation](#) and the adoption of the [EBA report 2016](#) show that MS in general welcome a further harmonisation in form of a directive building on well-functioning national systems. Changes to national covered bond-legislations put on hold pending an EU initiative also show an expectance of harmonisation.

B. Objectives and Policy options

The main objective will be to put in place a common set of EU requirements allowing the safe use of an EU covered Bond label across the Single market and justifying a preferential treatment in terms of capital requirements.

Moreover, a robust and attractive EU covered bond label could help markets to develop further. It should in particular make it easier to develop covered bonds markets in EU countries that do not have them yet, but also to attract investors from third countries. It should also help the due diligence process by investors, improve comparability across countries, reduce fragmentation and foster cross border investments in line with CMU objectives.

Finally, an EU legislative framework should better clarify the treatment of covered bonds in case of resolution: according to the EBA, several issues still remain to be clarified in the BRRD framework concerning the treatment of CBs under bail-in.

To achieve these objectives a first option would be to build on the current system and trying to improve it by promoting market led-initiatives or national regulatory action. For example, market-led initiatives have been established in order to voluntarily harmonise transparency practices (for example the ECBC Covered Bond label).

A second option would recognise the fact that the current EU rules outline only a few high level principles and contain several loopholes that would need to be filled in order to reach an effective and necessary level of harmonisation. Such an approach would reinforce the way EU currently defines the structural features of a covered bonds and the conditions under which it should be granted preferential treatment. It would however build on the strengths and specificities of existing national frameworks, and respect the characteristics of the national markets already working well.

A last option would be to fully harmonise both the structural and prudential aspects of covered bond regulation in order to ensure that only covered bonds complying with these detailed standards could be qualified as covered bonds and receive preferential treatment. No room or very limited room for national rules would be left in such a scenario of full harmonisation.

C. Preliminary Assessment of Expected Impacts

The main benefits of a harmonised EU framework for covered bonds would be a reduction of the overall default probability of covered bonds due to the strengthening of the credit characteristics of the instrument which would translate into materially lower borrowing costs for EU credit institutions. Harmonising will also secure a common ground for issuance of covered bonds beyond the possibilities of market driven initiatives, reducing regulatory fragmentation, facilitating reduction of asset and liability mismatches, facilitating capital market access to small and medium-sized issuers, and, reducing investors' reliance on external ratings.

The EBA also finds a need for harmonisation to justify maintaining the preferential treatment of covered bonds, which are a substantial feature in the continuous good pricing of the instrument. A better alignment of national covered bonds with the risk characteristics of the asset class and its regulatory treatment would justify its continued recognition under EU prudential rules,

EU legislation is likely to require Member States to adapt their legal frameworks. Adaptation of frameworks does imply potential risks and costs. In that context, particular attention should be paid to the need to avoid disrupting well-functioning regimes and markets while allowing adjustments to be made in order to comply with the new

regime. The new rules may require also issuers to establish new covered bond programmes. This would require that existing bonds and programmes would need to be grandfathered, which could create costs and liquidity problems. Other transition costs may arise in the form of administrative costs for issuers in implementing the changes, for example as a result of changing legal documentation or amending IT systems.

Likely economic impacts

Main impacts will concern the priority of a deeper and fairer economic and monetary union.

Covered bonds represent an important source of long-term funding for EU credit institutions and have an important role regarding liquidity and placement of funds for credit institutions and other financial institutions. The outstanding volume of covered bonds (€2.1 trillion in the EU in 2015) represents 4.8% of the balance sheet of EU banks and 1.2 times the outstanding volume of corporate bonds issued by non-financial institutions in the EU.

Covered bonds facilitate the refinancing of mortgage loans and public sector loans, thereby supporting lending more broadly. Covered bonds finance an average of 30% of residential mortgages lending in the EU in 2015 with a certain degree of variability across countries (in Denmark 100% of residential mortgages are financed through covered bonds, in Sweden this percentage is 60%, in Finland 37%. Still above one third in Mediterranean countries: Spain, Italy, Portugal. The percentage is 23% in France and 16% in Germany).

Covered bonds' lower risk profile reduces the required rate of return for investors and enables mortgage banks to raise finance more cheaply than by just issuing unsecured bank bonds.

Covered bonds are also an important financial instruments for the CMUs: although residential mortgages finance predominantly real estate, entrepreneurs can also use their residential property as collateral for financing their professional activity; commercial mortgages finance business facilities (offices, productive capacity and shopping malls, etc.); public sector loans finance local infrastructure (like schools, hospitals etc.) and possibly guarantee SME loans; finally, covered bonds in some cases also refinance other assets such as SME loans and infrastructure loans.

Harmonizing the product at EU level and making it more easily accessible cross-borders, while at the same time increasing the number of jurisdictions into this market and the respective size, is therefore beneficial for the credit capacity of banks. Covered bonds indeed represent a cheaper source of funding for EU banks than unsecured bonds, and, in addition, a likely impact of a harmonised EU framework would be a strengthening of the credit characteristics of the instrument which would translate into materially lower borrowing costs for EU credit institutions.

Likely social impacts

Main impact on the housing and real estate markets.

Covered bonds are mainly used to refinance mortgages (> 80%) and, to a lesser extent, other asset classes (public sector loans, infrastructure, shipping loans, SME loans etc.). Therefore, they are particularly important to finance real estate. Mortgages (around €7 trillion) represent 16% of total assets in the EU banking sector (€43.3 trillion) and 30% of the total loans provided by EU banks (€23.5 trillion in 2015). In terms of percentage of residential lending, covered bonds cover an average of 30% of residential mortgages lending in the EU in 2015. This means that almost one third of residential real estate lending in the EU is financed through covered bonds.

There is a certain degree of variability across countries. There are MS such as Denmark where 100% of residential mortgages are financed through covered bonds. In Northern countries (Sweden and Finland) the percentage is also quite high (between 60% and 37%). Slightly lower, but still above one third is in Mediterranean countries (Spain, Italy, Portugal). It is lower in France (23%) and in Germany (16%), however still significant. Developing this market across borders would therefore help financing residential real estate with the social implications this may have.

Likely environmental impacts

An environmental friendly version of covered bonds has been launched as a market initiative. Green Covered Bonds are backed by green and energy-efficient mortgages portfolios. Considering this initiative is slowly taking off, a favourable legislative EU framework could broaden their appeal for borrowers and investors alike and accelerate their development with positive environmental implications.

Likely impacts on fundamental rights

No likely impacts on fundamental rights can be foreseen for this initiative.

Likely impacts on simplification and/or administrative burden

The initiative of harmonizing covered bond framework at EU level would reduce the burden of due diligence for investors when they invest in covered bond markets across borders. It could reduce costs and time currently needed to undertake separate analysis for the covered bonds of each Member State based on their different legal frameworks. Such costs create barriers to entry for smaller or less sophisticated investors and inhibit issuance in Member States where the market is smaller.

D. Data Collection and Better Regulation Instruments

Impact assessment

An impact assessment is being prepared to support the launch of an EU covered bond framework and to inform the Commission's decision in this respect.

Data collection

The Commission in March received a [study](#) commissioned from a third party (ICF). The study assesses the current market performance and the costs and benefits of potential EU action.¹ On the basis of a literature review; qualitative and quantitative analysis and stakeholder interviews (issuers, investors, supervisors...), the study documents a number of costs and benefits of EU action. The EBA published a [Report on Covered Bonds](#) in December 2016 advocating for harmonisation of the instrument.² The report documents the current diversity in the national covered bond frameworks in legal, regulatory and supervisory terms. While there are similarities (e.g. related to dual recourse and the coverage principle), there are variances in the frameworks in the area of special public supervision as well as in relation to the disclosure of data, liquidity buffers, composition of the cover pool, and stress testing. In light of these differences, the EBA recommends comprehensive action at EU level in order to justify maintaining the favourable treatment granted to covered bonds.

Consultation strategy

On 30 September 2015, as part of the CMU Action Plan, the EC launched a [Public Consultation](#) to gather stakeholders' views on whether and how to develop a pan-European covered bond framework. The public consultation closed 6th January 2016. The Commission received 76 responses, from stakeholders located in 16 Member States and Norway. Following the closing of the public consultation, in February 2016, a conference has been organized by DG FISMA to follow up to the consultation. The [EBA Report on Covered Bonds](#) has been published after a public hearing held in November 2016. The methodology used for the [ICF study](#) has been based on stakeholder interviews and an online survey, for a total of 106 organizations consulted in the period between November 2016 and February 2017. As a follow-up to the public consultation and collection undertaken by the EBA and ICF, the Commission continues to liaise with stakeholders through stakeholder meetings and targeted consultations on key aspects of the proposal to help further substantiate the analysis of the available policy alternatives in line with Better Regulation guidelines.

Will an implementation plan be established?

Parts of the possible legislation that will be undertaken in the form of a Directive will require national transposition measures. As implementing rules may need to co-exist with supplementary national legislation, it will be important to assist MS in their transposition process on the basis of a pre-established transposition plan aiming at ensuring timely and adequate implementation and good coordination with the national level. As part of the follow-up to the implementation of the new rules, indicators monitoring effects on the ground will be put in place in order to measure to what extent the objectives set by the initiative will be met.

¹ ICF (2017), "Covered Bonds in the European Union: Harmonisation of legal frameworks and market behaviours". Study for the European Commission (May 2017).

² EBA (2016), "Recommendations on harmonisation of covered bond frameworks in the EU". EBA-Op-2016-23, 20 December 2016. This follows a previous Report on Covered Bonds published in 2014.