



EUROPEAN CENTRAL BANK

EUROSYSTEM

EN

ECB-PUBLIC

OPINION OF THE EUROPEAN CENTRAL BANK

of 9 April 2018

on the legal framework for covered bonds

(CON/2018/18)

Introduction and legal basis

On 28 February 2018 the European Central Bank (ECB) received a request from the Ministry of Finance of the Czech Republic for an opinion on a draft law proposing amendments to Act No. 190/2004 Coll., on Bonds¹ and certain other laws (hereinafter the 'draft law').

The ECB's competence to deliver an opinion is based on Articles 127(4) and 282(5) of the Treaty on the Functioning of the European Union and the third and sixth indents of Article 2(1) of Council Decision 98/415/EC², as the draft law relates to Česká národní banka (CNB) and rules applicable to financial institutions insofar as they materially influence the stability of financial institutions and markets. In accordance with the first sentence of Article 17.5 of the Rules of Procedure of the European Central Bank, the Governing Council has adopted this opinion.

1. Purpose of the draft law

- 1.1 The main purpose of the draft law is to comprehensively reform the current system of covered bonds in the Czech Republic. The draft law seeks primarily to eliminate identified deficiencies within the current covered mortgage bonds regime, to modernise the regulatory framework for covered bonds and to harmonise national laws with those adopted by other Member States. In this respect, the draft law aims to ensure that covered bonds are (a) financial instruments which meet European standards and market requirements; (b) of good quality and tradeable on the financial market; (c) an attractive investment opportunity for investors, including those outside the banking sector and abroad; (d) of high liquidity and credit quality on the markets, even in times of financial distress; and (e) a suitable and effective source of long-term funding, which support the liquidity position and financial stability of issuers.
- 1.2 As noted in the explanatory memorandum accompanying the draft law, both investors and credit rating agencies consider the current legal framework in the Czech Republic for the issuance of covered bonds to be inadequate for a number of reasons, particularly in comparison with the legal framework in place in many other Member States. The existence of deficiencies within the current covered mortgage bonds regime makes mortgage covered bonds currently issued by Czech banks

¹ *zákon č. 190/2004 Sb., o dluhopisech.*

² Council Decision 98/415/EC of 29 June 1998 on the consultation of the European Central Bank by national authorities regarding draft legislative provisions (OJ L 189, 3.7.1998, p. 42).

under Czech law less attractive to international investors. The most material deficiencies include (a) the ambiguous status of cover pools (cover assets) as part of the insolvency estate of an issuer under Czech insolvency law; (b) potential conflicts of interest between the interests of an insolvency trustee and the holders of mortgage covered bonds; and (c) the acceleration of the liabilities of an issuer under mortgage covered bonds that occurs by operation of law in case of a declaration of bankruptcy by the insolvency court.

- 1.3 The draft law establishes a category of 'covered bonds' that will serve as an umbrella category encompassing mortgage covered bonds (as provided for under the current Act No. 190/2004 Coll., on Bonds), public covered bonds and mixed covered bonds.
- 1.4 Under the draft law, covered bonds may only be issued by banks incorporated under Czech law and which have their registered office in the Czech Republic. Other EU credit institutions or branches of other EU credit institutions may not issue covered bonds.
- 1.5 The draft law clarifies that the cover pool can be formed by various specified assets, including: assets listed under Article 129 of Regulation (EU) No 575/2013 of the European Parliament and of the Council³; mortgage loan receivables; receivables from a member state (or central bank of a member state) of the Organisation for Economic Co-operation and Development (OECD), a multilateral development bank or international organisation of which an OECD member state is a member; receivables the repayment of which is guaranteed by one of the abovementioned public entities; bank account receivables; ancillary derivative receivables; *in rem* collateral security provided to an issuer in connection with such derivative contracts; rights to collateral security provided in connection with the assets constituting the cover pool (primarily mortgages created in connection with mortgage loan receivables); rights arising under insurance policies; and rights arising from contracts entered into in connection with the administration of the covered block constituted by the assets contained in the respective cover pool. These assets must be either registered in a cover pool register maintained by the issuer, or, if not in a cover pool register, assets must be appropriately recorded by the issuer.
- 1.6 The draft law also introduces the concept of a covered block, consisting of the cover pool and the liabilities of the issue arising under the respective covered bonds. Issuers may create more than one covered block, which allows them to create different collateralisation levels for different parts of covered bond issues. The draft law allows for transfers of covered blocks subject to the approval of CNB.
- 1.7 The draft law introduces several collateralisation covenants. In particular, the covenants applicable on a portfolio basis require that the ratio between the aggregate value of the assets included in the respective cover pool and the aggregate nominal amount of the respective covered liabilities does not fall below 102% when excluding assets referred to under Article 129(2) of Regulation (EU) No 575/2013 and ancillary derivative receivables or below 85% when excluding assets referred to under Articles 129(1)(c) and 129(2) of Regulation (EU) No 575/2013 and ancillary derivative

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).

receivables and bank account receivables. The draft law also proposes to remove the 70% loan-to-value covenant calculated on a portfolio basis as against the whole cover pool, which is currently applicable under Act No. 190/2004 Coll., on Bonds. Finally, the draft law also includes a stand-alone collateralisation covenant in which the ratio of the nominal amount (face value) of a mortgage loan included in the cover pool to the value of the respective mortgaged property must not exceed 100%. Under Act No. 190/2004 Coll., on Bonds, the current permissible ratio is 200%.

- 1.8 The draft law provides a legal basis according to which covered blocks may be subject to a *pro rata* haircut where this is beneficial to holders of covered bonds for which the value of the respective covered liabilities exceeds the value of the respective cover assets.
- 1.9 The draft law incorporates the concepts of a security agent and a covered bond monitor into Czech law, and clearly ring-fences assets held by the security agent from the security agent's insolvency estate for the benefit of covered bondholders.
- 1.10 The draft law clarifies the insolvency regime applicable to the cover pool and covered blocks. In particular, the draft law explicitly stipulates that the cover pool does not form a part of the insolvency estate of the issuer and that the commencement and operation of insolvency proceedings do not affect covered blocks. The draft law further clarifies that no bail-in or similar measures, generally applicable under either Directive 2014/59/EU of the European Parliament and of the Council⁴ or associated Union law, are admissible with respect to covered blocks.
- 1.11 Under the draft law, CNB is required to appoint a forced administrator for all covered blocks of an issuer where (a) insolvency or winding-up proceedings have been initiated with respect to the issuer; (b) the issuer is unable to discharge its liabilities as they fall due; (c) CNB applies any corrective measure in relation to the issuer which, in CNB's opinion, might have an adverse effect on the timely discharge of the issuer's liabilities under the covered⁵ bonds; or (d) where CNB applies any measure under Directive 2014/59/EU with respect to such issuer.
- 1.12 Finally, the draft law introduces the concept of contingent convertibles (CoCos) into Czech law.

2. Preliminary comment

This opinion focuses on the provisions of the draft law relating to the tasks conferred upon CNB and the new regime for covered bonds.

3. Tasks of the Czech National Bank

- 3.1 The draft law does not extend the current supervisory mandate of CNB. CNB is already the national authority competent for financial market supervision⁵, as well as the authority competent

⁴ 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 (OJ L 173, 12.6.2014, p.190).

⁵ See Art. 1 of the Act No. 6/1993 Coll., on the Czech National Bank (*§ 1 zákona č. 6/1993 Sb., o České národní bance*) in conjunction with Regulation (EU) No 1092/2010 of the European Parliament and of the Council of 24 November 2010 on European Union macro-prudential oversight of the financial system and establishing a European Systemic Risk Board (OJ L 331, 15.12.2010, p. 1).

for macroprudential policy in the Czech Republic⁶. CNB also has the supervisory and macroprudential powers necessary to fulfil these functions.

- 3.2 The new powers related to the supervision of the issuance of covered bonds under the draft law are not intrinsically different from CNB's existing powers with respect to the issuance of mortgage bonds and supervision over issuers of mortgage bonds⁷.
- 3.3 It follows that the draft law does not confer genuinely new tasks on CNB, but rather specifies certain new powers that CNB may use when carrying out the same tasks already discharged by CNB under its existing supervisory responsibilities. Consequently, the issue of assessing the conferral of new tasks on a national central bank from the perspective of the monetary financing prohibition does not arise in the case at hand.

4. Covered bonds law reform

- 4.1 The ECB welcomes the draft law's reform of the legal regime for covered bonds in the Czech Republic, taking into account the best practices identified by the European Banking Authority (EBA)⁸, which aims to eliminate identified deficiencies in the current regime, modernise the existing Czech regulatory framework, contribute to the development of the Czech capital market and improve the level of protection and legal certainty for investors. In particular, the ECB welcomes the draft law's objective to ensure that covered bonds issued under the draft law are financial instruments of good quality and that they provide a suitable and effective source of long-term funding, supporting banks' business models and overall stability⁹.
- 4.2 On 12 March 2018, the European Commission published a legislative proposal for a Union framework on covered bonds¹⁰. The Czech authorities are invited to take the proposal into account in the Czech legislative process, as appropriate.
- 4.3 The ECB welcomes the various elements of the draft law, including: the new concept of covered bonds; the possibility to create multiple covered blocks; the introduction of a covered block monitor and a security agent (including the ring-fencing of assets held by the security agent from the security agent's insolvency estate for the benefit of covered bondholders); the clarification of the insolvency treatment of covered blocks in the event of the issuer's insolvency; the clarification that no bail-in or similar resolution measures are possible in relation to covered bonds; and the requirement for issuers to maintain separate records on cover pools.

⁶ See Art. 2a of the Act No. 6/1993 Coll., on the Czech National Bank (*§ 2a zákona č. 6/1993 Sb., o České národní bance*).

⁷ See Art. 1 and 44 of Act No. 6/1993 Coll., on the Czech National Bank (*§ 4 a 44 zákona č. 6/1993 Sb., o České národní bance*), Act No. 190/2004 Coll., on Bonds (*zákon č. 190/2004 Sb., o dluhopisech*) and CNB Decree No. 164/2014, on keeping records of the coverage of mortgage bonds and information duties of a mortgage bond issuer (*vyhláška č. 164/2014 Sb., o evidenci krytí hypotečních zástavních listů a informačních povinnostech emitenta hypotečních zástavních listů*).

⁸ See the EBA Report on Covered Bonds: Recommendations on harmonisation of covered bond frameworks in the EU of 20 December 2016 (EBA-Op-2016-23), available on the EBA's website at www.eba.europa.eu.

⁹ See also paragraph 4.1 of Opinion CON/2017/36.

¹⁰ Proposal for a Directive of the European Parliament and of the Council on the issue of covered bonds and covered bond public supervision and amending Directive 2009/65/EC and Directive 2014/59/EU: https://ec.europa.eu/info/law/better-regulation/initiatives/com-2018-94_en.

4.4 The ECB would welcome further clarification of the draft law in a number of specific respects. First, the positive value of derivatives in the cover pool, not only their nominal values, should be taken into account in calculating compliance with the covenants to avoid undue volatility of the coverage ratios due to currency fluctuations, which may lead to unnecessary demands for additional collateral. Second, the regime applicable to derivatives collateral should be clarified, mainly to reflect the market practice of collateralisation in derivatives trading and the effects of close-out netting in this regard. Third, the rules applicable to derivatives in the cover pool should also apply to exposures specified in Article 129 of Regulation (EU) No 575/2013, as such exposures may also be in the form of derivatives. Fourth, the new regime should adequately reflect exposures in default for the purpose of calculating compliance with the cover pool covenants. Finally, the conditions under which CNB appoints the forced administrator of cover blocks should be specified very clearly (e.g., by deleting point d) and e) of Art. 32a of the draft law) in order to avoid a situation where CNB is forced to determine if a specific supervisory measure would have an adverse effect on the timely fulfilment of liabilities resulting from the covered bonds, or when a bank is safeguarded through a resolution measures and only after that a forced administrator needs to be appointed.

This opinion will be published on the ECB's website.

Done at Frankfurt am Main, 9 April 2018.

[signed]

The President of the ECB

Mario DRAGHI