



**EUROPEAN CENTRAL BANK**

**OPINION OF THE EUROPEAN CENTRAL BANK**

**of 25 April 2001**

**at the request of the Irish Department of Finance on a draft legislative proposal on a  
Mortgage and Public Credit Bond Bill**

**CON/2001/6**

1. On 14 March 2001 the European Central Bank (ECB) received a request from the Irish Department of Finance for an ECB opinion on a preliminary draft Mortgage and Public Credit Bond Bill.
2. The ECB's competence to deliver an opinion is based on Article 2 of Council Decision 98/415/EC of 29 June 1998 on the consultation of the European Central Bank by national authorities regarding draft legislative provisions<sup>1</sup>, as the legislative proposal contains provisions concerning a national central bank, as well as rules applicable to financial institutions insofar as they materially influence the stability of financial institutions and markets. In accordance with Article 17.5, first sentence, of the Rules of Procedure of the European Central Bank, this ECB opinion has been adopted by the Governing Council of the ECB.
3. The draft Bill makes provision for the designation and regulation by the Central Bank of Ireland (CBI) of special-purpose credit institutions designated by the CBI as a 'mortgage credit institution' and/or a 'public credit institution', respectively. Such designated mortgage and public credit institutions may issue mortgage and public credit securities, and these securities or any related hedge contracts would be secured on pools of underlying mortgage or public credit assets and other specified assets (i.e., deposits, tier one assets for ESCB monetary policy operations and other assets acceptable to the CBI). The CBI would be empowered to designate as a mortgage and/or public credit institution a credit institution which is carrying on relevant 'qualifying activities' only, which relate broadly to dealings in mortgage and public credit and related financing (including deposit-taking) and hedging activities. The ECB notes that, under the draft Bill, qualifying activities also include dealings in tier one assets for ESCB monetary policy operations and/or property which is, from time to time, included by a NCB, with approval of the ECB, in its national list of eligible tier two assets for ESCB monetary policy operations. The 'qualifying activities' requirement would imply that the majority of Irish credit

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<sup>1</sup> OJ L 189, 3.7.1998, p. 42-43.

institutions would have to establish special purpose credit institutions in order to issue mortgage or public credit securities.

4. The ECB welcomes this initiative to lay the legislative foundations for the issuance of mortgage and public credit bonds by Irish credit institutions. The ECB notes that the legislative and regulatory framework envisaged for the issuance of these asset-backed securities shares many common characteristics with similar structures in other member states of the European Community, including Austria, Denmark, Finland, France, Germany, Luxembourg and Spain. The ECB notes that the legislation has been explicitly designed by the Irish Government to bring Ireland in line with best practices in other European financial centres, taking into account that the introduction of the euro and the new monetary policy framework have led to the development of an integrated and competitive money market in the euro area. In this regard, the ECB understands that this initiative enjoys the support of both domestic Irish banks and building societies as well as credit institutions conducting cross-border operations out of Dublin's International Financial Services Centre. The ECB considers that the Irish Government's initiative will make a positive contribution to the integration of capital markets in the euro area.
5. The ECB draws attention to the criteria which assets must fulfil in order to be eligible as collateral for Eurosystem monetary policy and intra day credit operations. Under the ECB Guideline of 31 August 2000 on monetary policy instruments and procedures of the Eurosystem (ECB/2000/7)<sup>2</sup>, Annex I (General Documentation on Eurosystem monetary policy operations and procedures), Chapter 6.2 (Eligible Assets – Tier one assets), a number of eligibility criteria are specified to tier one assets consisting of marketable debt instruments fulfilling uniform euro area-wide eligibility for Eurosystem monetary policy and intra day credit operations.

First, the assets must be debt instruments. It is understood that the mortgage and public credit securities envisaged by the draft Bill will be structured as mortgage and public credit bonds only, and would therefore fulfil this requirement.

Second, the assets must meet high credit standards, and in the assessment of the credit standard of debt instruments, the ECB takes into account, *inter alia*, available ratings by market agencies as well as certain institutional criteria which would ensure particularly high protection of the holders. In this regard, debt instruments issued by credit institutions which do not comply strictly with the criteria set out in Article 22(4) of the UCITS Directive<sup>3</sup> are accepted in tier one only if each issue as such is awarded a rating (by a rating agency) which indicates, in the view of the Eurosystem, that the debt instrument meets high credit standards. The ECB notes that it

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<sup>2</sup> OJ L 310, 11.12.2000, p. 1.

<sup>3</sup> Council Directive 88/220/EEC of 22 March 1988 amending, as regards the investment policies of certain UCITS, Directive 85/611/EEC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investments in transferable securities (UCITS), OJ L 100, 19.04.1988 p. 31.

is the intention of the Irish Government that certain features of the instruments, including the high quality of the underlying assets and the preferential creditor status afforded to investors in the bonds, are designed to achieve a triple A rating.

Third, the assets must be located in the euro area (so that realisation is subject to the law of a Member State of the euro area), transferable in book-entry form and deposited with a national central bank or with a central securities depository which fulfils the minimum standards established by the ECB. The description of the standards for the use of eligible SSSs in the euro area can be found on the ECB's website ([www.ecb.int](http://www.ecb.int)). The ECB assumes that, following the establishment of mortgage and public credit institutions pursuant to the provisions of the draft Bill, further information will become available regarding the proposed procedures surrounding the issuance, custody and settlement of mortgage and public credit bonds.

Fourth, the assets must be denominated in euro.

Fifth, the assets must be issued (or guaranteed) by entities established in the EEA. In this regard, the ECB notes that under the draft Bill the CBI may only designate credit institutions that are incorporated in Ireland.

Sixth, the assets must, at least, be listed or quoted on a regulated market as defined according to the Investment Services Directive,<sup>4</sup> or listed, quoted or traded on certain non-regulated markets as specified by the ECB. In this regard, debt instruments issued by credit institutions which do not comply strictly with the criteria set out in Article 22(4) of the UCITS Directive are accepted in tier one only if they are listed or quoted on a regulated market as defined according to the Investment Services Directive and comply with the requirements of the Prospectus Directive<sup>5</sup>. Furthermore, market liquidity may be taken into account by the ECB when determining the eligibility of individual debt instruments. The ECB assumes that, following the establishment of mortgage and public credit institutions pursuant to the provisions of the draft Bill, further information will become available regarding the listing, quotation or trading of issued mortgage and public credit bonds on applicable markets.

Despite their eligibility, national central banks shall not, in general, accept as underlying assets debt instruments issued or guaranteed by the counterparty, or by any other entity with which the counterparty has close links, as defined according to Article 1(26) of the Banking Consolidation Directive.<sup>6</sup> However, exempt from the definition of close links are cases in which such debt

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<sup>4</sup> Council Directive 93/22/EEC of 10 May 1993 on investment services in the securities field, OJ L 141, 11.06.1993, p. 27 ff.

<sup>5</sup> Council Directive 89/298/EEC of 17 April 1989 coordinating the requirements for the drawing-up, scrutiny and distribution of the prospectus to be published when transferable securities are offered to the public, OJ L 124, 5.5.1989, p. 8 ff.

<sup>6</sup> Directive 2000/12/EC of the European Parliament and of the Council of 20 March 2000 relating to the taking up and pursuit of the business of credit institutions, OJ L 126, 26.5.2000, p. 1.

instruments are protected by specific legal safeguards, e.g. instruments which comply strictly with the criteria set out in Article 22(4) of the UCITS Directive.

Finally, all eligible assets must be usable in a cross-border context, implying that a counterparty can receive credit from the national central bank of the Member State in which the counterparty is established by making use of tier one instruments located in another Member State. The ECB assumes that, following the establishment of mortgage and public credit institutions pursuant to the provisions of the draft Bill, additional information will become available regarding the proposed cross-border usage of the mortgage and public credit bonds.

6. With respect to the question of close links, the ECB notes that the mortgage and public credit securities envisaged by the draft Bill would appear to be designed to comply strictly with the three criteria set out in Article 22(4) of the UCITS Directive. If, as laid down in Article 22(4) of the UCITS Directive, the Irish Government sends the Commission a list of the categories of bonds together with the categories of issuers authorised, in accordance with the draft Bill and the supervisory arrangements contemplated by the draft Bill, to issue bonds complying with the criteria set out in Article 22(4), and assuming the procedure laid down in Article 22(4) is applied, the mortgage and public credit bonds will normally, without further action, automatically qualify as tier one assets eligible for Eurosystem monetary policy and intra day credit operations both by the parent entity of the relevant designated credit institution and by other Eurosystem counterparties.
7. The first criterion set forth in the UCITS Directive arises out of the reference in Article 22(4) to “certain bonds when issued by a credit institution which has its registered office in a Member State and is subject by law to special public supervision designed to protect bond-holders”.

In this regard, as noted above, under the draft Bill the CBI may designate any credit institution that is established in Ireland and holds an authorisation from the CBI as a mortgage or public credit institution eligible to issue mortgage or public credit securities, and that the issuance of such securities would be confined to such institutions. The ECB notes that, under the draft Bill, it shall be a criminal offence for any person to act as a mortgage or public credit institution or hold itself out as such unless designated as a mortgage and/or a public credit institution by the CBI. The ECB also notes that the draft Bill makes provision for the revocation by the CBI of an entity’s designated credit institution status, that the CBI may also apply to the Irish High Court for an order revoking an institution’s designation in a wide variety of circumstances and that such a revocation would be without prejudice to either a designated credit institution’s obligations in respect of any mortgage or public credit securities issued by it prior to revocation or the security of the holders of such securities over underlying mortgage or public credit assets.

The ECB also notes that, under the draft Bill, every mortgage or public credit institution is required to establish and maintain separate mortgage and public credit asset registers containing

particulars of every pool asset securing its obligations under mortgage or public credit securities and related hedge contracts, as well as a separate hedge contract register, and that no entries in these registers may be made or altered without the approval of the ‘cover asset monitor’, a person appointed by the designated credit institution with the approval of the CBI to monitor observance by the credit institution of its obligations under the draft Bill (and in particular that the required level of assets is maintained in the relevant asset pools following the issuance of securities or entry into related hedge contracts). The ECB also notes that the CBI may make regulations in respect of cover asset monitors, including the qualification, selection, appointment, removal and functions of cover asset monitors and requirements concerning information reporting by the cover asset monitor to the CBI.

The ECB also notes that, under the draft Bill, on the occurrence of a potential insolvency event with respect to a designated credit institution or a matured insolvency event with respect to its parent entity or the revocation by the CBI of a credit institution’s designated status, the CBI may request the Irish National Treasury Management Agency (NTMA) to locate an alternative service provider to perform the designated credit institution’s functions in relation to the administration and servicing of mortgage or public asset securities, related hedge contracts, assets, asset pools and registers, or locate a parent entity for the designated credit institution or act itself as alternative service provider for the institution.

Finally, the ECB notes that under the draft Bill, it shall be a criminal offence for any person to knowingly provide false or misleading information to the CBI, a cover asset monitor, the NTMA or any alternative service provider in the exercise of their respective functions.

8. The second criterion to which Article 22(4) of the UCITS Directive refers is that “sums deriving from the issue of these bonds must be invested in conformity with the law in assets which, during the whole period of the validity of the bonds, are capable of covering claims attaching to the bonds”.

In this regard, the ECB notes that the draft Bill specifies numerous conditions applicable to mortgage or public credit securities and pools, including matching requirements in relation to the duration, aggregate principal amount and currency denomination of, or interest payable on, assets comprised in the mortgage or public credit pools, as compared to outstanding mortgage or public credit securities issued. With respect to mortgage credit assets in particular, the draft Bill contains required loan-to-value (LTV) ratios with respect to underlying property assets, as well as an overall limitation on mortgage assets secured on commercial property. The ECB notes that while no limit or restriction applies to the inclusion in a mortgage or public credit pool of mortgage or public credit assets situated in a member state of the European Economic Area (EEA), an overall limitation applies to the inclusion of mortgage or public credit assets situated in Canada, the U.S., Switzerland and/or Japan, while mortgage or public assets situated in any other state which is a ‘Zone A’ state for purposes of the Banking Consolidation

Directive, as amended, supplemented or replaced) may only be included in the mortgage or public credit pool if so provided in, and in accordance with, regulations made by the Minister for Finance. The ECB also notes that, under the draft Bill, the CBI may by regulations provide for the valuation basis, valuation methodology, time of valuation and any other matter relating the prudent market valuation of mortgage credit assets. Finally, it is noted that a designated credit institution shall not at any time issue mortgage or public credit securities if the aggregate principal amount of such securities that are in issue would exceed a multiple of 50 (or such other multiple as may be specified from time to time) of its own funds (determined in accordance with the Banking Consolidation Directive and the Capital Adequacy Directive<sup>7</sup>, as amended, supplemented or replaced).

9. The third criterion to which Article 22(4) of the UCITS Directive refers is that “in the event of a failure of the issuer, [such assets] would be used on a priority basis for the reimbursement of the principal and payment of the accrued interest.”

In this regard, the ECB notes that the draft Bill provides, *inter alia*, that, notwithstanding any rule of Irish insolvency law, or the occurrence of a potential or matured insolvency event with respect to a designated credit institution or related company, the claims of a holder of mortgage or public credit securities issued by that designated credit institution shall continue to be valid and legally enforceable against the issuer, and that the assets comprised in the cover asset registers and related asset pools shall not form part of the designated credit institution’s assets for the purpose of any insolvency proceeding. The ECB takes particular note of the draft Bill’s provisions to the effect that the claims of a holder of mortgage or public credit securities issued by a designated credit institution shall, subject to considerations of fraud or misrepresentation under Irish law, rank, as respects recourse to assets comprised in the relevant asset pools, (a) senior and in priority to all claims and rights of any member, shareholder and other creditors of whatever kind (whether secured, unsecured or preferred by any other statute or laws) of that institution; (b) rateably and *pari passu* in all respects with other holders of mortgage or public credit securities, related hedge counterparties and cover asset monitors; and (c) junior to any fees or costs payable to the NTMA or any other alternative service provider appointed on the occurrence of a potential or matured insolvency event with respect to a designated credit institution or its parent entity, or upon the revocation by the CBI of a credit institution’s designated status.

Also, it is noted that while the draft Bill provides that a designated credit institution which has any mortgage or public credit securities outstanding shall not grant or suffer to subsist any security over pool assets or property situated in Ireland, a designated credit institution may grant or permit to subsist security over mortgage or public credit assets in an asset pool where

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<sup>7</sup> Council Directive 93/6/EEC of 15 March 1993 on the capital adequacy of investments firms and credit institutions, OJ L 141, 11.6.1993, p. 1 ff.

the relevant assets are situated outside Ireland and the persons having the benefit of such security are those entitled to security over the relevant assets under the draft Bill (e.g., the holders of securities). It is suggested that it may be appropriate to extend the prohibition on the creation of security interests in favour of third parties to pool assets or property situated outside Ireland.

10. The ECB notes that the draft Bill provides that the Minister for Finance may, after consultation with the CBI, by regulations (i.e., secondary legislation) confer on the CBI such additional functions connected with the CBI's functions under the Bill as the Minister considers appropriate, and that the draft Bill also provides that the Minister and the CBI may make regulations in respect of designated credit institutions generally, and with respect to a wide variety of specific matters addressed by the Bill. The ECB notes that, insofar as any Ministerial regulations affect the powers of the CBI as designator and regulator of designated mortgage and public credit institutions, consideration may need to be given to consulting the ECB in accordance with Article 2 of Council Decision 98/415/EC of 29 June 1998 on the consultation of the European Central Bank by national authorities regarding draft legislative provisions.
11. The ECB understands that a number of the draft Bill's provisions, including some of the provisions discussed in this opinion, are still under discussion by interested parties, including the CBI and interested market participants. Insofar as those provisions of the draft Bill which delineate the precise powers of the CBI as designator and regulator of designated mortgage and public credit institutions are the subject of substantive amendments, the ECB would appreciate being provided with the final draft Bill that will be presented by the Minister for Finance to the Oireachtas.
12. The ECB confirms that it has no objection to this ECB opinion being made public by the competent national authorities at their discretion.

Done at Frankfurt am Main on 25 April 2001.

*The President of the ECB*

[signed]

Willem F. DUISENBERG