OPINION OF THE EUROPEAN CENTRAL BANK
of 3 January 2019
on the legal framework for covered bonds
(CON/2019/1)

Introduction and legal basis
On 27 November 2018 the European Central Bank (ECB) received a request from the Estonian Ministry of Finance for an opinion on a draft law on a covered bonds framework¹ (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 sixth indent of Article 2(1) of Council Decision 98/415/EC², as the draft law relates to the rules applicable to financial institutions insofar as they materially influence the stability of financial institutions and markets and to the basic task of the European System of Central Banks (ESCB) to implement monetary policy pursuant to the first indent of Article 127(2) of the Treaty. 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 purpose of the draft law is to set up a legal framework for the issuance of covered bonds by credit institutions and to foster the Estonian capital markets and increase financial stability.

1.2 The draft law: (a) defines the institutions permitted to issue covered bonds, i.e. credit institutions with an additional authorisation for the issuance of covered bonds; (b) outlines the additional authorisation procedures concerning issuers and applicable additional requirements including the powers of the cover pool monitor; (c) outlines the general conditions for issuing covered bonds and specifies when the term covered bonds may be used; (d) specifies the types of covered bonds, i.e. mortgage covered bonds and mixed asset covered bonds, and the assets eligible for inclusion into the cover pool; (e) sets out rules on valuation, composition and structure of the covered bond portfolio; (f) sets forth special provisions for the separation of the covered bond portfolio, e.g. in the event of an issuer’s insolvency, the requirements for a cover pool administrator and the liquidation and transfer of a separated covered bond portfolio; (g) sets out transparency and disclosure requirements; and (h) establishes rules regarding supervision of covered bonds.

1.3 According to the draft law, in order to issue covered bonds, the issuer must be authorised as a credit institution and have an additional authorisation for the issuance of covered bonds. The

¹ Pandikirjaseadus, eelnõu.
additional authorisation must be obtained from the Estonian Financial Supervision Authority (EFSA) prior to the first issuance of covered bonds and is granted for an indefinite period. The additional authorisation may be revoked, inter alia, where the issuer has provided false or misleading information or documents, has repeatedly or significantly breached the requirements of the draft law, is unable to meet its obligations under the covered bonds, its activities endanger the interests of the investors or other clients of the issuer, or the issuer has not issued covered bonds within five years from receiving the additional authorisation or since the last redemption of previous covered bonds.

1.4 The draft law lists the following assets as primary assets eligible for inclusion into the cover pool: (a) for mortgage covered bonds: loans issued to natural persons, secured by mortgages over residential real estate located in the European Union; (b) for mixed asset covered bonds: loans issued to natural or legal persons, secured by mortgages over residential and commercial real estate located in the European Union, as well as credit to or debt securities of Member States of the European Union, their regional or local authorities and bodies governed by public law. These assets are regarded as primary assets of the cover pool and must represent at least 80% of the total value of the cover pool; the remaining part of the cover pool may be composed of substitute assets.

1.5 In addition to primary assets, the cover pool may include substitute assets. The draft law lists which assets may be used as substitute assets. These assets are (a) claims against or claims backed by members of the ESCB or central governments, public sector institutions, regional governments or local municipal government units of Union member states; (b) claims against or claims backed by third-country central banks, central, regional and municipal governments and various public institutions, multilateral development banks and international organisations – the draft law does not impose any additional quantity restrictions if the assets correspond to credit quality step 1 and imposes a limit of 20% of nominal value of the outstanding covered bonds for assets corresponding to credit quality step 2; (c) claims against credit institutions and investment firms that meet credit quality step 1, provided that such claims do not exceed 15% of the nominal value of the outstanding covered bonds; (d) claims against Union credit institutions and investment firms that meet the credit quality step 2, which have a maturity date of up to 100 days, provided that such claims do not exceed 15% of the nominal value of the outstanding covered bonds; and (e) net claims arising from derivative agreements, provided that such claims do not exceed 12% of the nominal value of the outstanding covered bonds.

1.6 The quality of the cover pool must be ensured by the issuer throughout the entire lifetime of the covered bonds by monitoring and updating the valuation of the covered assets secured by mortgages. At all times the cover pool must exceed the sum of the present value of the covered bonds and the net obligations arising from derivatives by at least 2%. This requirement is

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3 See Section 6 of the draft law.
4 See Sections 25(1) and 30(1) of the draft law.
5 See Sections 19(1) and 20(1) of the draft law.
6 See Section 20(1) of the draft law.
7 See Sections 18(1) of the draft law.
considered to be fulfilled if the aggregate nominal value of assets in the cover pool exceeds the aggregate nominal value of the covered bonds by at least 5%. In any case the nominal value of the cover pool must at all times at least equal or exceed the nominal value of the covered bonds.

1.7 To mitigate the liquidity risk of the covered bonds portfolio, a liquidity reserve must be formed which may consist only of level 1 and 2A assets and certain exposures to credit institutions as listed in the draft law which meet specified additional criteria. The minimum amount of liquidity reserves must be calculated for the following 180 days based on the difference in daily cash flow between the payments for the covered bonds and derivatives entered in the covered bond register and the revenue from underlying assets. Thereafter, the sum of such accumulated daily differences is calculated for the next 180 days and the largest negative result of such calculations must be covered by the liquidity buffer.\(^8\) The liquidity reserve should be at least 2% of the nominal value of the assets in the cover pool.

1.8 The draft law allows the issuer to mitigate risks arising from covered bonds with derivative instruments and to include such agreements in the cover pool subject to certain requirements, including that derivative transactions are made under a framework agreement that allows for netting and that derivative transactions do not automatically terminate upon the insolvency of the issuer. The primary and substitution assets, the liquidity reserves and the derivative instruments must be entered in a cover pool register maintained by the issuer.

1.9 For the purposes of ensuring sufficient collateral and compliance with applicable requirements, the draft law obliges the issuer to appoint an independent cover pool monitor whose responsibilities include, among others, ensuring that covered bond portfolio stress tests are conducted in compliance with applicable regulations and that there are sufficient cover assets and that these cover assets comply with the requirements\(^9\). Under the draft law, the authorisation to issue covered bonds can be sought only if the name and approval of a person to act as a cover pool monitor have been included in the application for authorisation.

1.10 The draft law pre-defines situations where the covered bond portfolio is separated from the issuer and specifies that in such cases the right to manage the covered bond portfolio is transferred to a cover pool administrator. One such circumstance is the insolvency of the issuer. Separation of the covered bond portfolio is intended to segregate the cover pool from the issuer, including from the bankruptcy estate of the issuer. After segregation, the cover pool will constitute a pool of assets, which, together with the income received therefrom, may be used only for the satisfaction of the claims of the respective covered bondholders and claims arising from derivative instruments, and to cover the costs of managing the cover pool\(^10\). To the extent that the proceeds of the cover pool are insufficient to satisfy in full the claims of covered bondholders, covered bondholders have recourse to the issuer’s bankruptcy estate for the balance of the claim, ranking \textit{pari passu} with unsecured creditors\(^11\).

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\(^8\) See Sections 21(3) of the draft law.
\(^9\) See Sections 12 to 14 of the draft law.
\(^10\) See Section 33 and 34 of the draft law.
\(^11\) See Section 53(2) of the draft law.
1.11 The draft law allows, with the approval of the EFSA, the whole covered bond portfolio to be transferred to another Estonian credit institution that has been granted a licence to issue covered bonds and which has not during the last five years repeatedly or materially breached requirements applicable to it as an issuer. The covered bond portfolio may also be transferred, with the approval of the EFSA, to a credit institution incorporated in another Member State. A transfer to a credit institution incorporated in another Member State is allowed if that credit institution proves that it meets certain conditions: (a) the credit institution fulfils the requirements applicable to a credit institution and to an issuer and has not during the last five years repeatedly or materially breached such requirements; (b) the rights of bondholders and derivative counterparts are secured at least to the same extent as they are in Estonia; (c) the rights of the debtors of claims in the cover pool are protected at least to the same extent as they are in Estonia and the transfer would not cause additional costs or other burden to the debtors; (d) the acquirer’s home state law permits the acquisition of the covered bonds portfolio; and (e) the acquirer has all the required approvals and licences. The acquirer must present a legal opinion in order to satisfy conditions (b), (c) and (d).

1.12 The EFSA is tasked with supervising the issuer of the covered bonds and the activities of the cover pool administrator to ensure compliance with the standards of the draft law and requirements stipulated in other applicable legal acts. The supervisory powers of the EFSA are the same as envisaged in other relevant legal acts. The EFSA specifically has the additional right to request transfer of additional assets into the cover pool, the removal from the cover pool of assets that do not meet the requirements of the law, the conduct of a stress test, the change of cover pool monitor, etc. 12

1.13 For the draft law to take effect, several delegated regulations still need to be adopted.

2. General observations

2.1 The ECB welcomes the aim of the draft law to establish a legal framework for issuing covered bonds, thereby diversifying the sources of potential financing for credit institutions and further developing the financial markets in Estonia. As previously noted, the ECB is in favour of a developed, harmonised, high-quality and transparent covered bond market in the Union. 13 The Eurosystem accepts covered bonds which fulfil the eligibility criteria for collateral in Eurosystem monetary policy operations. The ECB has issued several opinions expressing its views on covered bonds legislation in various Member States 14 with the aim of ensuring further convergence towards common high standards in covered bonds in all Member States.

2.2 The Union is taking considerable steps to ensure harmonised and common high standards regarding covered bonds across Members States. To this end, the Commission has published a legislative proposal for the Union framework on covered bonds on 12 March 2018 including a

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12 See Section 56(4) of the draft law.
13 See paragraph 2.1 of the Opinion CON/2018/37. All ECB opinions are published on the ECB’s website at www.ecb.europa.eu.
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\(^\text{15}\) (hereinafter the ‘proposed directive’) and a 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\(^\text{16}\), on both of which the ECB has opined\(^\text{17}\). Also, the European Banking Authority (EBA) has identified best practices in relation to covered bonds.\(^\text{18}\) Nevertheless, Union legislative proposals are still developing. The Estonian authorities are invited to continue to follow the ongoing drafting of the proposed directive and to take this into account in the Estonian legislative process, including as regards the various delegated regulations that are to be introduced under the draft law, as appropriate.

3. Specific observations on the draft law

3.1 In order to ensure a continuously high level of supervision over the issuers of covered bonds, an appropriate oversight system should be in place. Thus, the ECB welcomes the additional licencing and supervisory regime to be introduced in relation to credit institutions intending to issue covered bonds.\(^\text{19}\) The ECB notes that the draft law’s provisions regarding the right to both issue and revoke additional general authorisations for the issuance of covered bonds must be interpreted in line with Council Regulation (EU) No 1024/2013\(^\text{20}\). In particular, Article 4(1)(a) of Regulation (EU) No 1024/2013 gives the ECB the exclusive task of authorising credit institutions and withdrawing authorisations of credit institutions. In accordance with Article 6(4) of Regulation (EU) No 1024/2013, the ECB exercises this responsibility both for significant and less significant institutions. The ECB understands that this task is exercised for all banking activities listed in Annex I of the Directive 2013/36/EU of the European Parliament and of the Council\(^\text{21}\) as well as for any additional activity allowed under national law, such as the general authorisation to issue covered bonds as provided for under the draft law. Furthermore, the ECB is competent to ensure that the prudential risks arising from covered bond issuances as well as from investments in covered bonds are adequately managed and assessed by credit institutions. For the sake of clarity, any possible authorisation for a specific covered bond programme or supervision of covered bonds as a financial product would be considered as a product-specific regulation and, as such, to fall under the supervision of a national competent authority.

\(^{17}\) Opinion CON/2018/37.
\(^{19}\) See Section 3 et seq. of the draft law.
3.2 As regards publication requirements in relation to the granting of the covered bonds authorisation, the ECB understands that these will be duly exercised in line with the ECB’s confidentiality and data protection regime.

3.3 It is the understanding of the ECB that the referred licencing regime would require an application prior to the first issuance of covered bonds and that no obligation to give the EFSA an ex ante notification prior to the issuance of subsequent covered bonds or prior to the establishment of a new covered bond programme will be introduced. The attention of the Estonian legislature is drawn to the best practices and recommendations identified by the EBA; an ex ante approval obligation prior to any new covered bond programme and a notification obligation for subsequent issuances are recommended even in cases where a special licencing regime exists for credit institutions aiming to issue covered bonds.

3.4 The ECB welcomes the mandatory appointment of the cover pool monitor and its specified duties which include, among others, to ensure that the stress tests conducted on portfolios of covered bonds comply with applicable regulations and that there are sufficient cover assets and that these cover assets comply with the requirements set out in the law. In order to further facilitate investor due diligence and enhance transparency, consideration should be given to making the results of the portfolio stress tests, including the parameters used, publicly available.

3.5 The draft law does not include any statutory maturity extension triggers and allows for contractual maturity extension triggers if they meet specific conditions. Moreover, the draft law does not specify those circumstances which the issuer cannot control which would be a pre-condition for maturity extension. In the ECB’s experience, it is not possible to fully exclude discretionary triggering of a maturity extension. By allowing the extension triggers to be contractually defined, the proposed directive could result in significant heterogeneity across covered bonds, which hinders harmonisation. Since the proposed directive will be a minimum harmonisation directive, Member States are free to go further when transposing the proposed directive into national law. The Estonian legislature is therefore invited to consider further limiting the conditions under which a maturity extension of covered bonds can occur, and to allow only statutory maturity extension triggers with a set of specific conditions as proposed by the EBA. These measures strengthen the high quality of the cover pool and harmonisation. According to the EBA’s proposal, the maturity extension may only be effected upon the following triggers taking place (both triggers must occur simultaneously): (i) the covered bond issuer must have defaulted and (ii) the covered bond breaches certain pre-defined criteria/tests, indicating a likely failure of the covered bond to be repaid at the scheduled maturity date. The Estonian legislature could consider replacing the

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22 See Section 8(1) of the draft law.
23 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), page 72 and 131.
24 See Section 14(1) of the draft law.
25 The ECB understands that under Section 17(4) the contractual maturity extension triggers are severely limited, the triggers must not be influenceable by the issuer and it must be possible to determine the maturity date at all times.
27 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), page 137. See also paragraph 4.3 of Opinion CON/2018/37.
condition requiring an ‘issuer default’ with a condition which refers to the circumstances in which the covered bond portfolio is considered to be separated (as specified in Section 33(1) of the draft law). Alternatively, it could consider requiring that any extension of maturity must have the permission of the cover pool administrator.

3.6 The ECB welcomes the detailed specification of the requirements for the cover pool assets including the primary cover pool assets, the substitution assets and the liquid assets – this should help ensure that the covered bonds are of high quality.

3.7 The proposed directive specifies that a Member State shall ensure investor protection by providing for a sufficient level of homogeneity of the assets in the cover pool so that they shall be of a similar nature in terms of structural features, lifetime of assets or risk profile. The need to ensure homogeneity has been emphasised by both the ECB and the EBA and therefore primary cover assets consisting of one asset class are preferable. The draft law introduces two different types of covered bonds: (a) mortgage covered bonds, whereby the primary assets in the cover pool must be only residential mortgage loans, i.e. credit provided to natural persons which is secured by mortgages over residential real estate, and (b) mixed asset covered bonds, whereby the primary assets in the cover pool may be residential mortgages as well as other assets listed in the draft law, such as commercial mortgages and public sector assets. Although primary cover assets consisting of one asset class are preferable for mixed asset covered bonds, the Estonian legislature should consider including further provisions to ensure that the assets in the cover pool are of a sufficiently similar nature and that the composition of the cover pool does not materially change over time. The legislature is also invited to introduce requirements to better ensure the homogeneity of the cover pool over time.

3.8 The ECB notes that the cover pool liquidity buffer should cover the entire net liquidity outflow for 180 calendar days, as liquidity buffers should also cover potential issuer insolvency scenarios. Therefore, it is suggested that Section 21(3) of the draft law be clarified to make it clear that the cover pool liquidity buffer covers the full net liquidity outflow of the covered bond programme for 180 days, and not just the largest negative result on a daily basis over the next 180 days. The ECB appreciates the introduction of a minimum cover pool liquidity buffer of at least 2% of the nominal value of the cover pool assets. The ECB welcomes the fact that the Estonian legislature has not resolved to use the option under the proposed directive that would enable disapplication of the covered bond portfolio liquidity requirements for certain periods, subject to rules on liquidity specified in other Union legal acts and understands that under the draft law, liquid assets in the form of securities may be held on the account of the issuer in a manner that these assets are deemed to be unencumbered in accordance with Commission Delegated Regulation (EU)

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28 See Article 10 of the proposed directive.
30 Section 25 of the draft law.
31 Section 30 of the draft law.
33 See Article 16(4) of the proposed directive.
2015/61 to avoid potential double liquidity requirements. In this respect it should be clarified that such liquid assets may only contribute towards those liquidity requirements up to the amount of the net liquidity outflow of the covered bond programme.

3.9 Consideration should be given to clarifying that for the calculation of the cover pool liquidity buffer in the case of principal redemptions for covered bonds with extendable maturity structures, the scheduled maturity date instead of extended maturity date is to be used, unless the maturity date has been extended.

3.10 The ECB welcomes the fact that level 2B assets are not permitted as contributions to the cover pool liquidity buffer and that assets cannot be own-issued. In order to enable a rapid liquidation if necessary, the Estonian legislature may consider provisions ensuring a sufficient level of diversification of the cover pool liquidity buffer.

3.11 The high quality of assets in the cover pool is one of the key elements in ensuring confidence in the whole asset class and ensuring the dual-recourse nature of the claims by bondholders. The draft law specifies that claims should not be in default at the time of inclusion in the cover pool. The ECB would suggest that the Estonian legislature should also consider obliging issuers to exclude on an ongoing basis from the calculation of coverage any claims already in default or likely to default.

3.12 Under the proposed directive, Member States are to lay down rules for derivative contracts that could be included in the cover pool. This would include at least the eligibility criteria applicable to hedging counterparties. The draft law lays down general conditions for eligible counterparties. The drafting notes to the draft law specify that the aim of these conditions is to ensure that a counterparty of any hedging arrangement is also sufficiently solvent during turbulent market conditions. The ECB welcomes the consideration given to this issue, but more specific qualitative and quantitative conditions could be introduced to ensure that the hedging counterparty used is sufficiently solvent and that potentially costly re-hedging would not have to be undertaken. These could include triggers related to the creditworthiness of the hedging counterparty (i) for collateralising the derivative exposure or (ii) for the replacement of the hedging counterparty.

3.13 For an instrument such as a covered bond to be effective, the title over the assets in the cover pool must be transferable following the separation of the covered bond portfolio from the originator (e.g. to enable the transfer of the entire covered bond portfolio under the draft law). The assets in the

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35 See Section 25(4) and Section 30(3) of the draft law.
36 See paragraph 3.1 of Opinion CON/2018/37.
37 Under Section 23(1)(2) of the draft law the following entities are considered to be suitable counterparties: (i) credit institutions, investment firms, management companies, investment funds, insurance undertakings and other financial institutions subject to financial supervision; (ii) the Republic of Estonia, foreign states, regional governments or the central banks of Estonia or a foreign state; (iii) international institutions or organisations, including the International Monetary Fund, the ECB, and the European Investment Bank; and (iv) financial institutions whose only business activity is investment in securities, market traders in commodities and commodity derivatives.
39 See Section 45 et seq. of the draft law.
cover pool consist of credit agreements. In general, national contractual laws require approval to be obtained from the counterparty to the agreement prior to transferring it to a third party. The ECB understands that for Estonian law-governed agreements such counterparty approvals are excluded by the draft law. For agreements governed by other national laws than Estonian law it is unclear, and perhaps unlikely, that an obligation to seek approval from the counterparty can be overridden by Estonian national law. Hence, the issuer of covered bonds must itself ensure that the transfer of non-Estonian law-governed agreements in the cover pool is valid and enforceable. It is suggested that the Estonian legislature includes a specific obligation to this effect in the draft law. In addition, the legislature is invited to consider encouraging issuers to obtain pre-approvals from all debtors under the credit agreements it wishes to include in the cover pool, in order to ensure legal certainty regarding the transferability of the covered bond portfolio after separation of the portfolio from the originator.

3.14 The ECB welcomes the fact that the draft law clarifies the cases in which the right to manage the covered bond portfolio is transferred to a separate cover pool administrator. The draft law could clarify that in the event of transfer of the entire covered bond portfolio this transfer of the right to manage covers all forms of overcollateralisation, as well as overcollateralisation provided on a voluntary basis.

3.15 The existence in any covered bond law of obligations that require sufficient information to be provided to investors to facilitate adequate due diligence by investors is a key feature in encouraging investor confidence. The ECB welcomes the disclosure obligations introduced into the draft law but considers that the issuers should be obliged to include further information in their reports. This could include in addition various levels of overcollateralisation, separate lists of international securities identification numbers (ISINs) for covered bonds issued, loan-to-value distributions and the valuation and indexation method, an overview of transaction parties and in addition a glossary with definitions. In addition, the disclosure standards are still evolving in the Union and it is important to ensure that the level of disclosure remains sufficient over time and in keeping with market practices. This requires that the national authorities monitor the type and level of detail of information that must be disclosed as a minimum requirement. To enable flexible amendments to these provisions of the draft law, the Estonian legislature could consider introducing a right for an appropriate national body to modify the specific scope of disclosure obligations, for example by authorising such a body to issue a disclosure template in the form of a delegated regulation under the draft law.

3.16 The draft law envisages the adoption of several delegated regulations which have not been provided to the ECB. These includes regulations on (i) maintaining the covered bonds register; (ii) the calculation of the present value of collateral assets; (iii) the methodology of stress testing the covered bond portfolios; and (iv) the additional requirements relating to the independent value of real estate securing a mortgage loan, including the reporting, methodology and procedure for

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40 See Section 45(8) of the draft law.
41 See paragraph 4.3 of Opinion CON/2017/36.
42 Section 55 of the draft law.
valuation⁴³. The use of delegated regulations would provide an effective means to ensure the flexibility of the draft law in this respect. The national authorities should remain mindful of regulatory developments in the Union when drafting such regulations.

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

Done at Frankfurt am Main, 3 January 2019.

[signed]

_The President of the ECB_

Mario DRAGHI

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⁴³ See Sections 11(9), 18(8), 22(3) and 28(2) of the draft law.