

EU Covered Bonds Directive – 2022 Update

Introduction

In March 2018, the European Commission proposed a dedicated EU framework for covered bonds which included both a new EU Directive and an implementing EU Member States regulation. The new EU framework for covered bonds will come into effect in Ireland on 8 July 2022 following the entry into force of the European Union (Covered Bonds) Regulations 2021 (“**Irish Covered Bonds Regulation**”). The Irish Covered Bonds Regulation gives effect to Directive (EU) 2019/2162 of the European Parliament and of the Council of 27 November 2019 (“**Covered Bonds Directive**”) which enters into force on the same date.

Covered bonds are debt obligations issued by credit institutions and secured against a pool of assets which offer a dual recourse protection for bondholders. Covered bondholders have direct recourse as preferred creditors and they remain entitled to claim against the issuing entity as ordinary creditors. If the issuer fails, the bondholder has a direct and preferential claim against certain earmarked assets and an ordinary claim against the issuer's remaining assets. Covered bonds are subject to specific legislation to protect bondholders. Covered bonds are considered a stable source of investment, expanding the capacity of credit institutions to provide financing to the real economy such as the property market and public sector entities.

EU credit institutions are global leaders in the covered bond market. The EU covered bond market is a multi-trillion Euro market and is highly developed particularly in countries such as Denmark and Germany. Although the EU market is large and highly developed, it is also fragmented across EU Member States. Historically, covered bond issuance across the EU has been primarily regulated at a national level. As a result of this, the rules applicable to covered bonds can vary significantly across EU countries.

Covered Bonds Directive Framework – What’s New?

The Covered Bonds Directive aims to harmonise the regulation of covered bonds across all EU member states by:

- Setting out a clear definition of what a covered bond is;
- Clarifying the structural features of covered bonds to include the entitlement of covered bond investors to claims against the credit institution issuing the bonds and priority treatment for claims against the principal and interest upon the insolvency of the covered bond issuer;
- Setting parameters for eligible cover assets and liquidity requirements;
- Requiring credit institutions to be transparent in relation to the profile and risks associated with their covered bonds program; and
- Requiring Member State regulatory authorities to impose administrative and, if required, optional criminal penalties for breaches of covered bond rules.

Covered Bonds Directive and Irish Domiciled UCITS

Covered bonds issued before 8 July 2022 will not be impacted by the implementation of the Covered Bonds Directive in Ireland. These covered bonds will continue to be governed by the current requirements outlined in the Irish UCITS Regulations.

Under the current Irish UCITS Regulations, investment in covered bonds is not subject to the standard 5/10/40 diversification rules. UCITS funds may invest up to 25% of their net assets in any one covered bond and the total value of investments in covered bonds issued by one single issuer cannot exceed 80% of net assets. The existing Irish UCITS Regulations requires that for a UCITS fund to avail of the higher diversification threshold:

- The covered bonds must be issued by a credit institution which has its registered office in an EU Member State; and
- The sums deriving from the issue of covered bonds shall be invested in assets which, during the period of validity of the bonds, are able to cover claims attaching to the bonds in the event of the failure of the issuer.

When the new Covered Bonds Directive is implemented on 8 July 2022, UCITS funds will only be able to avail of the higher investment restrictions for covered bonds once they are certain that the covered bonds in question comply with the criteria outlined in the Covered Bonds Directive relating to eligible cover assets, composition of the cover pool, coverage and liquidity requirements, amongst others. Where UCITS funds wish to avail of the higher diversification thresholds for covered bonds, investment due diligence processes for UCITS funds will need to consider the criteria for compliance with the Covered Bonds Directive.

KB Associates' Services

KB Associates provides a range of services to investment funds including:

- The provision of UCITS management company/AIFM services.
- The provision of designated persons to perform UCITS business plan/AIFMD programme of activity functions.
- The provision of operational and compliance services to both UCITS and AIFMD compliant structures.

If you would like to discuss this note or KB Associates' services in general, please contact:

- Mike Kirby (+353 1 667 1980), mike.kirby@kbassociates.ie
- Andrew Kehoe (+353 1 613 6396), andrew.kehoe@kbassociates.ie