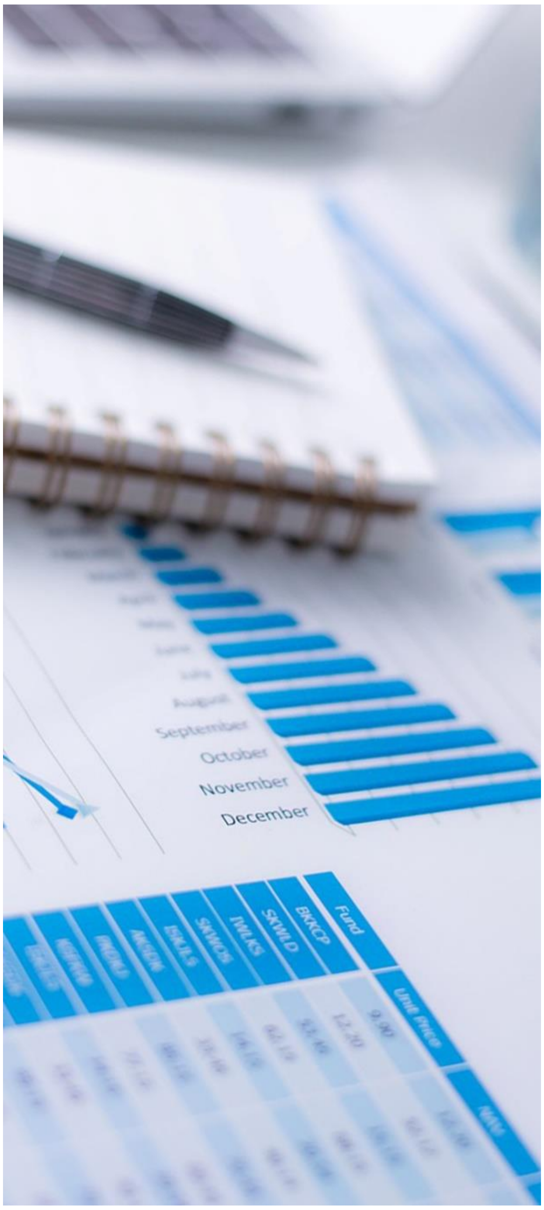
Covered bonds

Transposition of Directive 2019/2162

Legal flash

November 15, 2021

The Council of Ministers has approved *Royal Decree-Law 24/2021, of November 2,* transposing several EU directives ("RDL 24/2021"), including *Directive (EU) 2019/2162 of the European Parliament and of the Council of 27 November 2019 on the issue of covered bonds and covered bond public supervision and amending Directives 2009/65/EC and 2014/59/EU*.



Key aspects

- RDL 24/2021 groups together in a single legal instrument the previously dispersed regime for covered bonds, which in Spain includes mortgage-backed securities (*cédulas*) and bonds (*bonos*), public-sector covered securities and internationalization covered securities.
- It specifies which entities can issue covered bonds (credit institutions) and provides a single definition of "covered bonds."
- It harmonizes the criteria and sets the conditions for issuing bonds, and it determines the cover pool serving as collateral, the rules applicable in the event of insolvency and liquidation of the issuer, the cover pool monitor and the requirement to have a liquidity buffer.
- It provides for intragroup pooled covered bond structures, the use of joint funding and extendable maturity structures.
- It implements new rules on mortgage notes and mortgage transfer certificates.

General aspects of the regulation

RDL 24/2021 aims to dispel any legal doubts as to the situation of covered bonds and to prevent the credit quality perceived by the markets from deteriorating, in a competitive and integrated context, such as the EU financial markets.

RDL 24/2021 simplifies the legal system of the mortgage market and, particularly, the system set out in Act 2/1981, of March 25, regulating the mortgage market ("**Act 2/1981**"). Specifically, it repeals this act and the fourth additional provision of Act 5/2015, of April 27, on the promotion of business financing (the "**4th AP of Act 5/2015**").

The entry into force of Book One of RDL 24/2021 has been postponed until July 8, 2022 (a year from the transposition deadline), thus allowing for an adjustment period for operators in the sector. Moreover, this date coincides with the entry into force of *Regulation (EU) 2019/2160 of the European Parliament and of the Council of 27 November 2019 amending Regulation (EU) No 575/2013 as regards exposures in the form of covered bonds*. To strengthen the quality of covered bonds, the regulation amends article 129 of *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* (the "**CRR**") and it introduces a series of further requirements allowing covered bonds to benefit from the preferential prudential treatment provided under that article.

Under the first transitory provision, between the date RDL 24/2021 comes into force and the date on which the legal regime for covered bonds provided in Book One comes into force, any securities and bonds that are issued will continue to be governed by the provisions of Act 2/1981, among others. Mortgage notes and mortgage transfer certificates issued before Book One of RDL 24/2021 comes into force (on July 8, 2022) will continue to be subject to the rules governing them when they were issued until their maturity date, namely Act 2/1981 and the 4th AP of Act 5/2015.

Covered bonds

Below are the most noteworthy aspects of the new regime applicable to covered bonds.

Concept, types and labeling

RDL 24/2021 provides a single definition of "covered bonds": debt obligations issued by credit institutions under the provisions of this royal-decree law that are secured by a pool of assets to which bond investors have direct recourse as preferred creditors (dual recourse mechanism).

Depending on the primary asset class included in the cover pool, it defines the following categories: mortgage-backed securities, public-sector covered securities, internationalization covered securities, mortgage-backed bonds, public-sector covered bonds, internationalization covered bonds, and other covered bonds affixed with the agreed commercial denomination.

The difference between securities (*cédulas*) and bonds (*bonos*) lies in the open-ended or closed-ended nature of the cover pool, which, in the case of bonds (whether mortgage-backed, public-sector bonds, internationalization covered bonds or other types of bonds) is closed throughout the life of the instrument, and in the case of securities (whether mortgage-backed, public-sector or internationalization covered securities) is open throughout the life of the instrument. Thus, securities (*cédulas*) are secured by a single cover pool made up of an open and variable portfolio.

The list of covered bonds is open, as another category has been added (namely, “other covered bonds”), allowing issuers to affix the commercial denomination they wish to give the covered bond.

The “European covered bond” label can only be applied to “other covered bonds” that meet the requirements laid down in RDL 24/2021. All other covered bonds—securities (whether mortgage-backed, public-sector or internationalization covered securities) or bonds (whether mortgage-backed, public-sector or internationalization covered bonds)—that meet the requirements laid down in the provisions of the regulation (including article 129 of the CRR), can use the label “European covered bond (premium)”.

Scope of application and features

RDL 24/2021 applies to covered bonds issued by credit institutions in or outside of Spain, in the latter case when they are issued subject to this regulation.

It is worth mentioning that the subjective scope of application differs from that envisaged in the draft bill on covered bonds published by the Ministry of Economic Affairs and Digital Transformation on June 25, 2021. The scope of application provided in the draft bill included bonds issued in Spain by credit institutions established in the European Union, and Spanish branches of credit institutions established in third countries outside the European Union.

Therefore, bonds issued by Spanish credit institutions in another Member State and labeled as “European covered bond” or “European covered bond (premium)” will be provided with the same legal protection as covered bonds issued in Spain under RDL 24/2021.

Legal system

As mentioned above, RDL 24/2021 repeals, among other regulations, Act 2/1981 and the 4th AP of Act 5/2015.

It provides for the supplementary application of the Spanish Capital Market Act and it excludes the issuance of covered bonds from the framework of Title XI of the Spanish

Companies Act (bond issuance system).

These issuances will not be registered in the commercial registry. Note also that covered bond programs require previous authorization from the Bank of Spain.

Covered bonds can be admitted to trading on regulated markets and on multi-lateral trading systems under the provisions of the Spanish Capital Market Act.

Priority and bankruptcy aspects

RDL 24/2021 includes some of the provisions provided under Act 2/1981, such as the principle of bankruptcy remoteness and that of dual recourse, which grants bond investors a special payment privilege over pools of assets, as well as direct recourse against the issuer.

It amends articles in the Spanish Civil Code relating to credits taking precedence over some of the debtor's movable properties (article 1,922), and the debtor's immovable properties and *in rem* rights (article 1,923), to classify the credits of the holders of covered bonds on the basis of the assets included in the cover pool, as well as credits considered specially privileged under article 270 of Royal Legislative Decree 1/2020, of May 5, approving the consolidated text of the Spanish Insolvency Act (the "**Insolvency Act**").

In the event of insolvency and liquidation of the issuing credit institution, the cover pool will be materially insulated or ring-fenced from the issuer's assets, creating a separate set of assets operating through legal transactions represented by a special administrator and which will be used to pay the bondholders, for the purpose of which several amendments have been made to the Insolvency Act.

The cover pool

RDL 24/2021 details the minimum amount of assets each issued bond must contain, guaranteeing investors that the value of all of the liabilities is covered by the credit rights corresponding to asset composition, plus a liquidity buffer consisting of high credit quality liquid assets, which must cover the maximum net cumulative cash outflow in the following 180 days.

To mitigate risks, particularly those relating to the interest rate, the cover pool may include derivative financial instruments.

RDL 24/2021 also defines elements for the valuation of assets included in the cover pool. Each asset must be valued at the time it becomes part of the cover pool, and its value must be updated periodically.

It also sets out the distinctive features of the different types of covered bonds. In the case of mortgage-backed securities, the value of the mortgage loans included in the cover may not exceed 60% of the value of the property securing the loan, or 80% if it is a residential property.

The assets must be accurately identified in a special register kept by the institution and supervised by the cover pool monitor. This register will allow the institution to keep these assets separate from the rest, and for the separated assets to be effectively incorporated in the event of insolvency or liquidation. This strengthens the legal certainty as well as the credit quality of the product.

Liquidity facilities

As a mechanism to facilitate the financing of the issuer through covered bonds, RDL 24/2021 allows (i) intragroup pooled covered bond structures, set up by several institutions belonging to the same group; and (ii) the use of pools of assets acquired from other entities.

RDL 24/2021 also introduces the possibility of automatically extending the bond program in certain circumstances, as long as this is provided in the documents relating to the issuance and with prior authorization from the Bank of Spain.

Public supervision and administrative penalties

To increase the protection of investors, stricter supervision procedures have been established, based on two axes:

- The issuer must appoint an independent body to permanently supervise the cover pool. This may be an internal or external body, and each issuance program must be authorized by the Bank of Spain, which will verify compliance of the requirements of suitability and independence provided in the act.

- The Bank of Spain is appointed as the supervising body in charge of permanently supervising the cover pool, from the supervising body's authorization to the authorization required for each bond issuance program.

A penalty system is also established to make sure the supervisor has the ability to respond in case of non-compliance. The established system and the classification of breaches and penalties is similar to the system set out under the rules applicable to credit institutions and will fall within the competence of the Bank of Spain.

Mortgage notes and mortgage transfer certificates

The new rules on mortgage notes and mortgage transfer certificates seek to foster and facilitate their use as instruments that simplify the transfer and mobilization of rights associated with mortgage credits and loans.

The legal regime applicable to mortgage notes and mortgage transfer certificates is provided in four additional provisions. These rules are necessary due to the repeal of Act 2/1981 and of the 4th AP of Act 5/2015.

Among the most noteworthy developments, it is clarified that for the purposes of section 8 of article 20 of *Regulation (EU) 2017/2402 on Securitization*, these instruments will only be considered negotiable securities if they are susceptible to being traded in a generalized impersonal way in a financial market.

For additional information, please contact Cuatrecasas.