European Commission - Fact Sheet

Capital Markets Union: covered bonds, cross-border distribution of investment funds and cross-border transactions in claims and securities

Brussels, 12 March 2018

How are today's proposals linked to the Capital Markets Union (CMU)?

The Capital Markets Union is one of the priorities of the Juncker Commission to strengthen Europe's economy and stimulate investments to create jobs. The CMU aims to mobilise and channel capital to all businesses in the EU, particularly small and medium enterprises (SMEs) that need resources to expand and thrive. While the CMU will be beneficial for all EU Member States, it will particularly strengthen the Economic and Monetary Union.

Building on progress already achieved since the launch of the CMU in 2015, today's proposals will boost the cross-border market for investment funds, promote the EU market for covered bonds as a source of long-term finance and ensure greater certainty for investors when dealing in cross-border transactions of securities and claims. This will help integrate EU capital markets further by facilitating cross-border operations and increasing legal certainty for companies.

The Commission is committed to put in place all building blocks of the Capital Markets Union by mid-2019. The measures presented today, and the remaining CMU proposals that will be presented by May 2018 make it possible that legislation can be adopted before European Parliament elections in 2019.

1. Covered Bonds

What are covered bonds and why is the Commission's proposal needed?

Covered bonds are financial instruments that are generally issued by banks to fund the economy. They are backed by a separate pool of assets to which investors have a preferential claim in case of failure of the issuer. The pool of assets usually consists of high quality assets, such as residential and commercial mortgages or public debt.The investors in covered bonds are usually institutional investors, such as banks, pension funds, insurance companies or asset managers, who seek a low risk and long-term investment.

In addition to the issuer's creditworthiness, the fact that an investment in covered bonds is secured by a separate pool of assets constitutes a second protection for investors against credit risk and the solvency of the issuer. This means that if an issuer is in default, the assets can cover the investors' claims. Moreover, if the assets in the covered pool fail to generate sufficient cash flows for the repayment of investors, banks/issuers are fully liable towards investors with their capital. This makes covered bonds safer for investors as compared to other mechanisms such as securitisation.

Issuing covered bonds enables EU banks to obtain cost-efficient funding. The funding obtained by banks from issuing covered bonds may be used to grant for example mortgage loans for housing and non-residential property as well as to finance public debt, ships and aircrafts.

Covered bonds fared well during the financial crisis and proved to be a reliable and stable funding source at a time as other funding channels dried up. However, diverse rules across Member States affect the credit strength of those instruments. In addition, covered bonds markets are unevenly developed across the Single Market. While they are very important in some Member States, they are less developed in others.

This is why the Commission is proposing EU rules that will establish common definitions and standards for covered bonds. The proposed new rules also address prudential concerns by ensuring that the features of covered bonds are in line with the risk profile that is underlying already existing EU-wide preferential capital treatment.

How big is the covered bonds market?

The covered bonds market is very developed in the EU. In December 2015, the outstanding volume of covered bonds reached €2.5 trillion globally, €2.1 trillion of which were issued by EU-based institutions. This constitutes 84% of the total at global level.

One of the reasons why the EU has a comparatively large market for covered bonds is that many Member States have longstanding legal national regimes for covered bonds in place. The largest markets in the EU are Germany (18% of the EU outstanding volume), Denmark (18%), France (15%), Spain (13%), Sweden (11%), Italy (6%) and the UK (6%). The four largest markets account for almost two-thirds of the EU market in 2015.

How are covered bonds currently regulated?

The issuance of covered bonds is currently regulated at national level. Regulatory regimes differ widely across Member States in terms of supervision, disclosure requirements and the composition of the pool of assets backing the covered bond.

At the EU level, in light of their low risk, covered bonds currently benefit from preferential prudential regulatory treatment under the Capital Requirements Regulation (CRR). However, existing Union law does not comprehensively address what constitutes a covered bond. As a result, the prudential treatment under the CRR may be granted to very different products, depending on the applicable national law. That is why harmonisation on an EU level is needed – to make sure covered bonds are safe, robust, and follow the same rules across the EU.

What are today's proposals about?

The proposals – which take the form of a Directive and a Regulation - aim to foster the development of covered bonds across the Union, particularly in those Member States where no market currently exists. By making a cost-effective and long-term funding source available, these rules will help financial institutions - in particular banks – to finance the economy. It will also increase cross-border flows of capital and investments. This will provide investors with a wider and safer range of investment opportunities, contribute to financial stability and help finance the real economy.

The proposed Directive:

- provides a common **definition** of covered bonds, which will represent a consistent reference for prudential regulation purposes;
- defines the **structural features** of the instrument (dual recourse, quality of the assets backing the covered bond, liquidity and transparency requirements, etc.);
- defines the tasks and responsibilities for the **supervision** of covered bonds; and
- sets out the rules allowing the use of the **'European Covered Bonds' label**.

The Regulation amends the Capital Requirements Regulation (CRR) with the aim of strengthening the conditions for granting preferential capital treatment by adding further requirements.

The proposal will reduce borrowing costs for the economy at large. The Commission estimates that the potential overall annual savings for EU borrowers would be between €1.5 billion and €1.9 billion.

What assets would be allowed to back covered bonds?

The Directive contains provisions to ensure a high quality of the assets in the pool backing the debt obligations. For example, it should be possible to determine the market value or mortgage lending value of the assets.

SMEs loans and infrastructure loans are unlikely to meet the requirements set in the Directive because they are riskier assets. The Commission is therefore assessing the merits of another instrument for SME loans and infrastructure loans, namely the European Secured Note (ESN), as announced in the CMU Mid-term Review. The ESN would follow the basic structural characteristics of covered bonds.

What previous work is the basis of today's proposal?

The Commission carried out a public consultation in 2015. It showed that most stakeholders welcome further harmonisation in the form of a principles-based directive, provided well-functioning national markets are not disrupted.

Today's proposals largely build on the European Banking Authority's recommendations which call for legislative action to harmonise covered bonds at EU level.

The European Parliament also adopted an own-initiative report in July 2017 entitled "Towards a pan-European covered bonds framework" which supports the harmonisation of covered bonds at EU level. Member States have also expressed support for principles-based EU legislation on covered bonds at expert group meetings.

What are the next steps?

The proposal will now be discussed by the European Parliament and the Council. Once adopted, an implementation period of 12 months is envisaged before the new regime starts to apply.

2. Facilitating cross-border distribution of investment funds

What are investment funds?

Investment funds are investment products created with the purpose of pooling investors' capital, and investing that capital collectively through a portfolio of financial instruments such as stocks, bonds and other securities.

Investment funds play a crucial role in facilitating the accumulation of personal savings, whether for major investments or for retirement. They are also important because they make institutional and personal savings available as loans to companies and projects, which ultimately contributes to growth and jobs.

How are investment funds currently regulated?

The two main existing pieces of EU legislation in the area of investment funds are the Directive on Undertakings for Collective Investment in Transferable Securities (UCITS) and the Directive on Alternative Investment Fund Managers (AIFM). The UCITS Directive provides for strong investor protection and creates a label for European retail investment funds. UCITS managers already benefit from a fully-fledged management passport, which allows them to provide their services across the EU without a residence requirement.

The AIFM Directive lays down rules for the authorisation, supervision and oversight of managers of non-UCITS funds, i.e. alternative investment funds (AIFs). EU managers benefit from an EU-wide passport to manage and market AIFs to professional investors across borders. Unlike UCITS, marketing AIFs to non-institutional investors is currently only possible at Member State discretion. Specific regulation already exists for three subcategories of AIFs, namely European Long Term Investment Funds (ELTIF), European Venture Capital Funds (EuVECA) and European Social Entrepreneurship Funds (EuSEF).

What is the Commission proposing to change and why are you making this proposal now?

The EU investment funds market has not yet exploited its full potential in terms of cross-border distribution. The majority of the total assets under management held by investment funds stem from their respective domestic markets. This initiative aims to eliminate current regulatory barriers to the cross-border distribution of investment funds in order to enable a better functioning Single Market and economies of scale.

The proposal, which consists in a Regulation and a Directive, is designed to improve transparency, remove overly complex and burdensome requirements and harmonise diverging national rules. More concretely:

1. The proposed Regulation improves transparency by aligning national marketing requirements and regulatory fees. It introduces more consistency in the way these regulatory fees are determined. It also harmonises the process and requirements for the verification of marketing material by national competent authorities. The Regulation enables the European Securities and Markets Authority (ESMA) to better monitor investment funds.
2. The proposed Directive harmonises the conditions under which investment funds may exit a national market. It creates the possibility for asset managers to stop marketing an investment fund in defined cases in one or several host Member States. It also allows European asset managers to test the appetite of potential professional investors for new investment strategies through pre-marketing activities.

What are the benefits of today's proposals?

Removing inefficiencies in the functioning of the Single Market for investment funds will reduce the costs for cross-border distribution and make it simpler, quicker and cheaper. This will accelerate the growth of cross-border distribution in the EU and will ultimately provide for more investment opportunities in the EU.

Currently 70% of the total assets under management are held by investment funds authorised or registered for distribution only in their domestic market. Only 37% of UCITS and about 3% of alternative investment funds (AIFs) are registered for distribution in more than 3 Member States.

The proposal will facilitate the cross-border distribution of investment funds by eliminating current regulatory barriers and making cross-border distribution less costly. The proposed measures are expected to save up to EUR 440 million annually in costs for existing cross-border distribution. More importantly, easier cross-border distribution is expected to accelerate the growth of the Single Market for investment funds and boost competition between asset managers.

Which asset managers will be affected?

All asset managers will be affected. The proposal will particularly help smaller players to start marketing their funds on a cross-border basis. At the same time, this will help large asset managers to expand across the EU.

Did the Commission consult on the proposals?

Respondents to the 2015 CMU consultation and the Call for Evidence [link?] said that regulatory barriers to the cross-border distribution of funds prevented the capitalisation of the Single Market's full benefits. Therefore in June 2016 the Commission launched a targeted open consultation on the cross-border distribution of investment funds. Additional input was sought through two surveys addressed to national competent authorities, submitted via the ESMA in 2016 and 2017 respectively, as well as targeted stakeholder consultations through numerous meetings with the fund industry and European investor associations.

What are the next steps?

The proposal will now be discussed by the European Parliament and the Council.

3. Law applicable to third-party proprietary effects of the cross-border assignment of claims

What is meant by a transaction in claims?

The assignment of a claim is a legal mechanism whereby a creditor ("assignor") transfers his right to claim a debt to another person ("assignee"). A claim gives a creditor the right to receive a sum of money or to the performance of an obligation by the debtor. This mechanism is used by companies to obtain liquidity and have access to credit, so-called factoring and collateralisation respectively, and by companies (most often banks) to optimise the use of their capital, also called securitisation.

An SME can assign a part of its current and future claims against clients in several Member States to an assignee, who, in return for a discount against the purchase price, is ready to agree to provide cash flow finance, collect the debts and accept the risk of bad debts. This process is called 'factoring' (see example below).

Example of factoring

An SME needs immediate cash to pay its suppliers. The invoices to its customers are only due for payment in three months. The SME (assignor) therefore decides to assign (sell) its invoices to an assignee (or 'factor') – which is in this case its bank – at a discount price in order to obtain immediate cash from the bank. The discount price at which the SME sells its invoices to the bank accounts for the bank's fees and commission.

What are third-party proprietary effects of the assignment of claims?

The proprietary elements or third-party effects of an assignment of claims refer in general to who has ownership rights over a claim and, in particular, to:

1. which requirements must be fulfilled by the assignee in order to ensure that he acquires legal title over the claim after the assignment (for example, registration of the assignment in a public register, written notification of the assignment to the debtor), and
2. how to resolve priority conflicts, that is, conflicts between several competing claimants as to who owns the claim after a cross-border assignment (for example, between two assignees where the same claim has been assigned twice, or between an assignee and a creditor of the assignor in the event of an insolvency).

What is the Commission addressing with its proposal?

With the increasing interconnectivity of national markets, a company can often assign a claim to an actor in another EU country, which can lead to a conflict of applicable laws. For cross-border situations, a number of Member States do not have clear rules on third-party effects of assignment of claims. The current uncertainty as to the applicable law creates a higher legal risk in cross-border transactions compared to domestic transactions.

The solution which the Commission proposes is a general rule that in conflict situations the law of the assignor's habitual residence applies. The law of the assignor's habitual residence is easy to determine and most likely to be the place in which the main insolvency proceedings with respect to the assignor will be opened. The proposal is also particularly suitable for bulk assignments and assignments of receivables under future contracts, which are an important source of finance for SMEs.

However, special rules are needed to cater for sectors which may not be well served by the rule of the law of the assignor.

This is why the law of the assigned claim applies to two types of specific claims, which are therefore exempted from the general rule:

- cash on the account of a credit institution (for example a bank, where the consumer is the creditor and the credit institution is the debtor);
- claims derived from financial instruments, such as derivatives.

In addition, for securitisation transactions, the Commission proposes a choice between the law of the assignor and the law of the assigned claim.

How will this proposal contribute to the CMU?

The Capital Market Union Action Plan identified differences in the national treatment of third-party effects of assignment of claims as one of the obstacles that stand in the way of cross-border investment in the Single Market. To remove this obstacle, the CMU mid-term review envisaged a targeted action in this area. The proposed Regulation will fulfil this objective by facilitating the trading in claims across borders. It will render cross-border transactions less risky and boost cross-border investment.

Who benefits from this proposal?

Claims are assigned in factoring, securitisation and as collateral in order to obtain credit. The following market players will benefit from the legal certainty this proposal brings to the cross-border assignment of claims:

- Borrowers (retail customers and firms, in particular SMEs);
- financial institutions (such as banks engaged in lending, factoring, collateralisation and securitisation); and
- financial intermediaries that transact in securities and claims, end investors (funds, retail investors).

Legal certainty will lead to increased availability of capital and credit across borders and to more affordable rates. This is particularly beneficial for small and medium-sized companies.

4. Communication on the law applicable to securities

How big are securities markets in the EU and how are they currently regulated?

At the end of 2016, EUR 52 trillion in securities were held in Central Securities Depositories ("CSD") accounts across the EU. Transactions in securities settled through EU CSDs amounted to EUR 1 128 trillion. ECB securities settlement statistics data suggests that in 2016 the estimated volume of cross-border investments reached EUR 10.6 trillion. This would mean that one in five securities is held by an investor resident in a Member State other than the Member States where the securities were issued.

National law applies when determining the so-called 'proprietary effects' (i.e. the validity of a transaction and the owner of the assets covered by the transaction) of a national transaction. In contrast, in cross-border transactions it is not always clear which country's law applies to determine the ownership of the assets concerned by the transaction. Currently, three Directives contain specific provisions on which national law is applicable to determine the ownership of securities in cross-border transactions: the Settlement Finality Directive (SFD), the Winding-up Directive (WUD) and the Financial Collateral Directive (FCD).

What is this Communication about and why it is needed?

This Communication outlines the Commission's views on the existing conflict of laws rules relating to securities transactions. Currently, national securities laws are not harmonised at EU level, this is why so-called 'conflict of laws rules' determine which national law applies in cross-border transactions.

The conflict of law provisions in the SFD, FCD and WUD apply on the basis of the place of the relevant register or account and in the case of the SFD and the WUD, the centralised deposit system. However, the provisions differ in detail and there appear to be some differences in how they are applied across Member States. In particular, the Directives lack clarity as regards the definition and determination of where the account is 'located' and 'maintained'.

Clarity on which national law is applicable is essential to be able to assess whether cross-border transactions are effective vis-à-vis third parties. It is important for parties to the transaction in question, as well as for other market participants who interact with these parties. This is especially true in case of several subsequent transactions when an actor challenges the ownership of securities. As a result, parties to a cross-border transaction have to carry out an assessment of potential risks and benefits of doing business based on a set of potentially applicable laws. This increases significantly the cost of legal advice needed for doing business.

This Communication presents the Commission's views as to how the relevant provisions of the SFD, FCD and WUD may be applied at present. The Commission is of the view that the difference in wording across the three directives does not imply any difference in substance. In addition, without prejudice to potential future decisions of the Court of Justice of the European Union, the Commission is of the view that all the different ways to determine where a security account is "located" or "maintained" under national law appear to be valid.

The Commission may assess in future – in light of international, technological of market developments – whether a different solution would achieve better results.

What are 'proprietary' aspects?

Two elements of securities transactions should be distinguished:

i. the proprietary element which refers to the transfer of rights in property and which affects third parties; and

ii. the contractual element, which refers to the parties' obligations towards each other under the transaction.

This Communication focuses on the first 'proprietary' element of securities transactions. The contractual element is already regulated at EU level by the Rome I Regulation.

What preparatory work has been done for this Communication?

This Communication is based on a public consultation held in 2017 with the objective to receive input from all concerned stakeholders. At the same time, the Commission consulted the European Post Trade Forum, set up a group of legal expert to examine alternative legislative solutions and consulted with Member States.

What are the next steps?

The Commission will continue to closely monitor developments in this area. Within the next five years, it will assess how national interpretations and market practices has evolved in light of international and technological developments. Furthermore, the impact of specific issues on the functioning of the internal market will be assessed.

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