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UCITS regime to be amended for EU fixed income products

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The European Commission (the "**Commission**") has published two legislative proposals for the establishment, at EU level, of enabling frameworks for sovereign bond-backed securities ("**SBBSs**") and covered bonds ("**CBs**").

Both proposals incorporate amendments to the provisions of the UCITS regime governing investment in these asset classes. For CBs, it is proposed to remove the current provision (Article 52(4) of the UCITS Directive) and replace it with a reference to CBs as defined under the Commission's proposal, while the draft framework for SBBSs proposes permitting UCITS to invest in these securities on a look-through basis i.e. as though they were sovereign bonds.

Covered Bonds

Currently, the regulation of CBs is subject to the requirements, if any, applicable under the national regime of the relevant home Member State i.e. there is no harmonised EU level framework for these securities. CBs only exist at an EU level by virtue of the preferential treatment they are afforded under the UCITS Directive. Pursuant to the Directive, UCITS are permitted to invest in up to 25% [provided that if a UCITS invests more than 5% in a single issuer the total investment in these bonds shall not exceed 80% of NAV] of NAV in bonds "*issued by a credit institution which has its registered office in a Member State and is subject by law to special public supervision deigned to protect bond-holders. In particular, sums deriving from the issue of those bonds shall be invested in accordance with the law in assets which, during the whole period of validity of the bonds, are capable of covering claims attaching to the bonds and which, in the event of failure of the issuer, would be used on a priority basis for the reimbursement of the principal and payment of the accrued interest.*" As such, while CBs are similar in construct to asset-backed and other securitised debt instruments, they are set apart from such instruments as the issuer retains the risk on its balance sheet and investors have recourse to the issuer in the event of its default.

Issuance and investment in CBs varies in popularity across EU Member States and one of the key objectives of the Commission's proposal is "*…to contribute to the development of covered bonds across the Union, particularly in Member States where no market for them currently exists." To achieve this, and other objectives outlined by the Commission in its proposal, a new framework is to be established which will "specify the core elements of covered bonds and provide a common definition as a consistent and sufficiently detailed point of reference for prudential regulation purposes, applicable across financial sectors.*"

The implementation of the proposal, therefore, necessitates the removal of the above mentioned provision from the UCITS regime and its replacement with a reference to CBs as defined under the Commission's proposal. The impact of this amendment to the UCITS Directive will be driven by the terms of the legislation ultimately adopted by the Parliament and the Council. However, it is clear from the proposal that, following its adoption, any investment in these instruments by a UCITS will be governed by far more extensive provisions than is currently the case.

The Commission's CB proposal was published last March and has been reviewed by the European Parliament, whose proposed amendments were published on 21 August 2018. The Parliament noted good progress on the part of the Commission towards the objectives of the proposal but also noted "*room for improvement*" in a number of areas.

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In terms of timing, the Commission's 'Completing the CMU by 2019-time to accelerate delivery' communication notes its desire to ensure adoption of its proposal by "*mid-2019 at the latest.*"

Sovereign bond-backed securities

In support of the CMU and also the Banking Union, the Commission published a proposal last May for the establishment of a framework for a "*new class of low-risk securities backed by a diversified pool of national government bonds*".

Under the current EU framework, the securitisation of sovereign debt would operate and be treated in the same manner as any other securitised debt instruments and therein lies the issue, being a lack of recognition of the low-risk nature of SBBSs, which the proposal seeks to address. "*SBBSs carry risks that are comparable to the underlying sovereign bonds rather than regular securitisations" and as such, it is "necessary that the regulatory framework is suitably adapted to capture the unique features of SBBSs*".

Pursuant to the Commission's SBBS proposal, SBBSs would be composed of Euro denominated EU member state issued bonds, the relative weight of which would be "*very close to the relative weight of the respective Member States' participation to the ECB capital key.*" The proposal details further eligibility and composition requirements for SBBSs including that the maturity of the underlings should be "*closely aligned to the maturity of the SBBS's issue*" and the SBBS should be composed of a senior tranche "*corresponding to 70% of the nominal value of the SBBSs issue and one or more subordinated tranches.*"

Significantly, entities issuing and holding SBBSs would be permitted to treat these instruments on a look-through basis i.e. as though they were sovereign bonds. Accordingly, the UCITS regime is proposed to be amended such "*that when Member States authorise UCITS to invest up to 100% in transferable securities issued or guaranteed by a public body, this exception is also granted to SBBSs.*"

On 27 August 2018, the European Parliament published a briefing of the EPRS (the Parliament's Research Service) detailing additional information on the proposal from the Parliament's perspective but noting that the "*process is still at an early stage*".

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