EUROPEAN CENTRAL BANK

EUROSYSTEM

OPINION OF THE EUROPEAN CENTRAL BANK

of 14 October 2010

on a legislative framework enabling credit institutions to issue covered bonds

(CON/2010/73)

Introduction and legal basis

On 13 September 2010, the European Central Bank (ECB) received a request from the Cypriot Ministry of Finance for an opinion on a draft law on covered bonds (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 on the third, fifth and sixth indents of Article 2(1) of Council Decision 98/415/EC of 29 June 1998 on the consultation of the European Central Bank by national authorities regarding draft legislative provisions[1], as the draft law contains provisions concerning the Central Bank of Cyprus (CBC) and relates to payment and settlement systems and to rules applicable to financial institutions insofar as they materially influence the stability of financial institutions and markets. 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 and outline of the draft law

The purpose of the draft law is to set up the legal basis for the issuance of covered bonds in Cyprus complying with Union legislation[2]. Accordingly, and in line with international legislative practice, the draft law regulates, in particular, (a) the eligibility of the issuers of covered bonds (all credit institutions, including cooperative credit institutions, incorporated in Cyprus are to qualify as 'eligible issuers')[3], (b) the eligibility of assets, primary or complementary, for inclusion in the cover pool[4], (c) the registration, in Cyprus, of foreign covered bonds (in case of a cross-border merger, involving the absorption of an issuing credit institution incorporated under European Economic Area law by another credit institution incorporated in Cyprus)[5], (d) the covered bonds' issuance model (covered bond pools are

1 OJ L 189, 3.7.1998, p. 42.

2 Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) (recast) (OJ L 302. 17.11.2009, p. 32) and Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions (recast) (OJ L 177, 30.6.2006, p. 1) (hereinafter 'CRD').

3 Article 6(1) of the draft law.

4 Article 2 (definition of the term 'asset') read in conjunction with Article 14(1)(d) and Article 18(2) of the draft law. CRD-compliance criteria for covered bonds will be the subject matter of the CBC Directive referred to in paragraph 2.2. of this opinion.

5 Article 14(4) of the draft law.

to remain separately identifiable in the issuer's balance sheet, rather than being transferred to a special purpose vehicle)[6], (e) the registration and supervision of eligible issuers and covered bonds (these tasks are to be the responsibility of the CBC, where the issuer is a bank, and of the Cooperative Societies' Supervision and Development Authority, where the issuer is a cooperative credit institution), and (f) the impact of insolvency proceedings on the rights of the covered bond holders and their preferential treatment (in the event of the issuer's insolvency, the covered bond holders are to have priority on the proceeds of the cover pool vis-à-vis all of the issuing bank's secured or unsecured creditors)[7].

2. General observations

2.1 The ECB welcomes the draft law and, in particular, its thorough, rules-based approach, reflecting the shared intention of the consulting authority and the CBC of setting up a comprehensive legal framework, permitting credit institutions incorporated in Cyprus to issue UCITS and CRD-compliant covered bonds under terms and conditions equivalent to those applicable to credit institutions incorporated elsewhere in the Union. At the same time, the ECB stresses the significant role of Union covered bonds for Union financial markets, the conditionality to which their privileged treatment under Annex VI to the CRD is subject and the importance of sound legal rules, allowing some measure of discretion to the competent authorities, for the safety, liquidity and transparency of covered bonds, both from the point of view of their conditional eligibility for Eurosystem monetary policy operations and from a broader, financial stability perspective.

2.2 The introduction to the explanatory memorandum states that the national authorities will complement the draft law with a CBC directive, which is currently undergoing a national consultation process. The directive in question would, *inter alia*, address issues of relevance to the assessment of the adequacy and quality of the cover pool, the CRD compliance of the covered bonds, and the issuers' disclosure requirements. The directive has not yet been submitted to the ECB for consultation. Taking into account the importance of the issues to be addressed in the directive for a meaningful assessment of the safety, liquidity and transparency of the covered bonds to be issued by credit institutions in Cyprus, the ECB will only address those aspects of the proposed legal and regulatory framework once the directive has been submitted to it for consultation.

2.3 The draft law disapplies, under 'Miscellaneous', specific sections or parts of the Laws on companies, banking and cooperative companies[8]. Moreover, as mentioned in the explanatory memorandum, the application of specific sections of the draft law, including those of relevance to the exercise by bondholders of their proposed right of recourse to the estate of the issuer, in case of the latter's insolvency, is conditional on the prior amendment to other relevant laws. However, neither the requisite amendments to the Law on banking[9] (expressly referred to in the explanatory

6 Article 14(1) read in conjunction with Article 18(1), (2) and (5) to (7) of the draft law.

7 Article 40(5) and (6), Article 41 and Article 43(1) of the draft law.

8 Articles 74 and 75 of the draft law.

9 Law 66(I)/1997, *Episimi Efimerida tis Dimokratias*, Annex I(I), No 3168, 18.7.1997.

memorandum), nor those that the ECB would expect to the Law on real estate[10] and transfer of banking business and collateral[11] have been made available to the ECB for its consideration. In light of the above, this opinion does not assess all the parameters for the eventual implementation of the draft law in Cyprus nor of its interplay with other relevant Cypriot legislation that may have an impact on the rights of bondholders, in particular, vis-à-vis the issuers of Cypriot law-governed covered bonds.

3. Specific observations

The draft law empowers the CBC and the Cooperative Societies' Supervision and Development Authority (CSSDA) to act as supervisors of eligible issuers and covered bonds. In order for the CBC and the CSSDA to be in a position to perform their registration and supervisory tasks effectively, it is essential that they dispose of sufficient human and material resources in addition to those that the CBC devotes to the pursuit of its ESCB-related tasks. The ECB notes, in this regard, that the draft law empowers the CBC and the CSSDA to require institutions to pay fees[12]. It also provides for the payment of a fee for inspecting the registers of approved institutions and covered bonds[13]. Moreover, given the separate supervision of banks and cooperative credit institutions, the ECB sees the need for close cooperation by the CBC and the CSSDA as supervisory authorities to ensure that the same material standards apply to the registration and supervision of eligible issuers and covered bonds in Cyprus, irrespective of their corporate organisation as banks or as cooperative credit institutions.

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

Done at Frankfurt am Main, 14 October 2010

[signed]

The President of the ECB

Jean-Claude TRICHET

10 Cap. 224.

11 Law 64 (I)/1997, *Episimi Efimerida tis Dimokratias*, Annex I(I), No 3168, 18.7.1997.

12 Article 71 of the draft law.

13 Articles 5(2) and 12(2) of the draft law, respectively.