HM Treasury, 1 Horse Guards Road, London, SW1A 2HQ

Sir William Cash
Chair
European Scrutiny Committee
14 Tothill Street
House of Commons
London
SW1H 9NB

21st November 2018

Dear Sir Bill,

7064/18: Proposal for a DIRECTIVE OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL on the issue of covered bonds and covered bond public supervision and amending Directive 2009/65/EC and Directive 2014/59/EU

7066/18: Proposal for a REGULATION OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL on amending Regulation (EU) No 575/2013 as regards exposures in the form of covered bonds

Thank you for your letter of 31 October on the EU covered bonds proposal, following our Explanatory Memorandum of 11 April 2018. In line with the timing we previously noted, we expect the package to go to a meeting of Permanent Representatives by the end of this month followed by a General Approach in December. I am writing to update you on what we expect the overall compromise agreement to look like.

The article on eligibility of assets remains balanced. Further to my last letter, the Presidency compromise text reflects a Member State's concern over the specificities of their existing covered bond market. We expect that the compromise text will provide a Member State option to include loans involving public undertakings, subject to certain safeguards on safety and soundness criteria.

Whilst we have reservations over the inclusion of exposures with a lower rating (credit quality step 3) into the covered bond framework, Member States have supported this and have shown flexibility in the spirit of compromise. This is to accommodate national specificities of some Member States who do not have enough credit institutions qualifying for higher ratings. Since my last letter, short-term exposures of this quality have also been included in the liquidity buffer and in the Regulation. However, the provision which clarifies that Member States can restrict the type of liquid assets eligible for the cover pool liquidity buffer remains.

The solution on the overlap between the liquidity buffer and the Liquidity Coverage Requirement (LCR) in the Capital Requirements Regulation is maintained since my last letter. We support the principle of a liquidity buffer specific to the covered bond programme, while trying to avoid duplicating liquidity requirements. If these requirements are not reconciled, firms will be subject to a double liquidity requirement for covered bond outflows. Therefore, the disapplication of the covered bond liquidity buffer requirement under certain criteria in the compromise text is a proportionate and appropriate way to deal with the issue.

On the issue of transitional measures, a grandfathering provision for covered bonds sold by the technique of 'tap issuance' has been introduced. This means that a bond can be reopened for additional offerings to the market after it has been initially introduced. This technique is uncommon in the UK but used more widely in other Member States. Without an appropriate grandfathering provision specific for tap issued covered bonds, pre-issued bonds won't reach the volumes originally intended, resulting in lower levels of liquidity and discouraging investors. We have therefore supported the inclusion of a Member State discretion to address this issue.

We have supported further discussion on third country equivalence. Since my last letter, the Presidency has taken into account the views of some Member States, including the UK, who believe that the timeframe of the report is too conservative. The Presidency's compromise text therefore shortens the review time in relation to equivalence by bringing forward the deadline to 2 years.

We believe there is a pathway to reaching a compromise that would serve as a robust EU framework and reflects the well-functioning UK covered bond market. With the expectation that a General Approach would be tabled next month, I would be grateful if the Committee finds themselves able to grant clearance, or waive scrutiny, to enable us to support an agreement.

On the European Parliament side, the Economic and Monetary Affairs Committee are due to hold a vote this month. Following this and once a General Approach is reached we expect trilogues to commence for an overall agreement to be found before the end of this European Parliament's term.

I am copying this letter to Lord Boswell of Aynho, Chair of the House of Lords European Union Committee; and copying this letter to Foeke Noppert, Clerk to the Commons Committee; Christopher Johnson, Clerk to the Lords Committee; Les Saunders, Department for Exiting the EU; Barbara Armstrong and Daniel Jones, HM Treasury.

With very best regards

John

JOHN GLEN