20 September 2018

EBF_033995

EBF POSITION ON THE LEGISLATIVE PROPOSALS ON COVERED BONDS [1]

Introduction and Overview

We specifically welcome the consistency of the proposed supervisory regime with a focus on covered bond public supervision and investor protection. Overall, the approach taken is balanced and covers in our view all necessary elements for a sound covered bond product, thus achieving the objective of justifying a preferential treatment in terms of capital requirements. However, the proposal reveals some uncertainties regarding its scope (eligibility of cover assets), the definition and use of hedging derivatives and the composition of cover pools that may hamper the well-functioning and cost-efficient market we have today.

Furthermore, we also welcome the proposed amendments of Article 129 CRR aiming at reinforcing and complementing the requirements for the preferential capital treatment of covered bonds.

In summary, our main concerns are as follows:

- Eligible assets: While the cover assets must be of high quality, the proposal only provides formal criteria to determine which assets are eligible for covered bonds. We are concerned that, when scrutinized, these criteria are not robust enough to ensure the high quality of the assets.

- Composition of the cover pool: There is no evidence that the composition of cover pools raises major concerns in capital markets and/or from investors. We therefore question the requirement to provide for a sufficient level of homogeneity of assets in the cover pool as this could lead to much higher systemic risk in these financial markets.

- Use of hedging derivatives: The proposals to set a limit on the derivative contracts in the cover pool could hence imply a limit on hedging capacity, which could contradict the benefit of using derivatives for hedging purposes and would be against the interests of the covered bond investor.

[1] 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 [Link]; 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 [Link];

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- Liquidity buffer: EBF considers the liquidity buffer requirements excessive, considering elements already in place in other regulation. We believe that the liquidity buffer requirement at the cover pool level would increase the funding costs.

EBF position

1. Scope and definition of a covered bond - Title II Structural Features (Articles 4-17)

The definition of a covered bond can currently be found in Article 52(4) of the UCITS Directive. The draft of the new directive aims at being more precise than the current UCITS definition, however it raises questions in relation to the core characteristics of a covered bond i.e. the structural elements in a definition of a covered bond. Title II of the directive states: "Structural Features of Covered Bonds". The elements under Title II (articles 4-17) appear all to be structural elements set up for a covered bond. If any one of the structural elements is not met, then it is not a covered bond.

It must be clear that a subsequent breach in relation to any of Articles 4-17 would not result in the case that the bond ceases to exist as a covered bond and consequently holders loses their priority in case of bankruptcy and preferential treatment (cf. Art 129 CRR) of the existing stock of covered bonds at the time of breach. In addition, this means that the specific treatment under EMIR as applicable for OTC derivatives in connection with covered bonds no longer will apply.

The amendments to CRR Article 129 should, as with BRRD and UCITS, refer to Article 3(1) in the directive so that the original intention of a harmonised treatment of covered bonds in EU could be achieved.

2. Eligible assets (Article 6)

We note that cover assets must be of high quality. While the referenced Article 129 (1) CRR provides some indication for the required quality level, the proposal does not really provide qualitative criteria allowing Member States to set more precise parameters. Instead, the proposal only provides formal criteria (valuation, legal certainty and enforceability) which don’t seem robust enough. We conceive the missing specification of the ‘high quality’ requirement as a qualitative uncertainty of the proposal. Concerns about the extent of eligible assets are also valid in our view when it comes to the listed collateral types. Charges, liens and/or other guarantees open certain room for interpretation and innovative structures potentially leading to a wider range of eligible assets than those traditionally accepted. However, charges, liens and/or guarantees which are widely

accepted in a certain Member State and which do not weaken the covered bond product, should be recognised as eligible collateral types.[2]

For asset classes (e.g. renewable energy), where a market value cannot be observed, the mortgage lending value has to be determined. So far, the wording of mortgage lending value is used in connection with assets where a prompt filling and registration of mortgages, charges, liens or guarantee on assets in the pool is required. For cases where this is not legally required, the lending value should also be calculable on an estimated realisation value without the necessity of using the multi pillar valuation model.

As stated under Recital 15, also public undertakings as defined in Article 2(b) of Commission Directive 2006/111/EC should be considered eligible to serve as collateral in the cover pool.

Furthermore, in Article 6(1), it is important to clarify that the listed requirements under (a) to (d) only apply to the 'other assets' which might be considered by Member States of high quality.

Finally, we also note an unspecified use of the term 'asset'. Cover assets consist of exposures and not of the attached security tools. As mortgages, charges, liens or guarantees represent the collateral for the cover assets, all requirements such as enforceability, legal quality and valuation rules should refer to the collateral and not to the cover assets. As an example, market or mortgage lending values refer to the assets. But as it is about valuation of properties, it should refer to the collateral and not to the assets. Similarly, Member States should lay down rules on valuation of the collateral (properties) instead of assets. The same applies to the enforceability requirement which must refer to the collateral and not to the cover asset.

3. Intragroup pooled covered bond structures (Article 8)

The requirement that "externally issued covered bonds" to be offered to investors outside the group excludes the possibility that these bonds may be retained on the balance sheet of the issuer's bank to be used as collateral against the ECB, which is a very common practice by banks.

Article 8(c) refers to externally issued covered bonds that are 'sold' to covered bond investors – this should be changed to 'offered'.

It is unclear whether the pooling within groups is also admitted on a cross-border level. We would welcome rules allowing cross-border intragroup poolings by adding a specific clarification to Article 8.

Article 8(b) should not be restricted to a 'claim' on the issuing institution, but also allow for a purchase of covered bonds as an option to create pooled covered bond structures within a group.

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[2] There is a long-standing market practice prevailing in Belgium of including mortgage mandates which is recognised in the European investor community.

As we see setting a credit quality requirement in Article 8(d) on both the internally and externally covered bonds to be used would give an unwanted rating volatility which should be avoided. This requirement should be deleted.

4. The Composition of the cover pool (Article 10)

Article 10 states that "Member States shall ensure investor protection by providing for a sufficient level of homogeneity of the assets in the cover pool so that they shall be of a similar nature in terms of structural features, lifetime of assets or risk profile."

This point is in contradiction with the EBA and European Commission's objective which is reiterated on page 4 of the Directive: "A fundamental aim of the approach in this package is to avoid disrupting well-functioning and mature national markets".

The term "lifetime of assets" is subject to different interpretation. In particular it would be highly problematic if the term is meant to reflect the time until maturity as individual mortgages included in the cover pool are naturally granted with different maturities. It would be appropriate to delete the reference to the "lifetime of assets".

The broadness of this article could be interpreted to mean that commercial and residential mortgages, or loans of different maturities, can no longer be included simultaneously in our cover pools.

In some Member States the entire mortgage portfolio - residential and commercial loans with different maturity terms - serves as collateral for the covered bonds issues, so that the homogeneity of article 10 interpreted in the strict sense would be impracticable. On the other hand, this diversity of the covered assets has never been a problem, given the sufficient level of collateralization, and thus the level of protection enjoyed by investors and the transparent information given to market regarding the composition of the cover pool.

Under strict interpretation, Article 10 can mean that a large part of assets in the credit and capital market will convert to the same maturity in most legislations. That will mean much higher systemic risk in these financial markets.

We challenge the need for rules addressing the composition of cover pools and therefore propose the deletion of Article 10. There is no evidence that the composition of cover pools raises major concerns in capital markets and/or from investors. Full transparency of cover pools is provided. What is not dysfunctional should not be regulated.

Should this Article nevertheless be maintained, it shall be made clear that the sufficient level of homogeneity does not refer to the lifetime of assets neither impedes he composition of mixed pools, that is residential and commercial mortgage loans being both eligible for the same cover pool (mortgage cover pool). The wording of this article should be in line with the best practice 3-A published by the EBA[3] on the importance of a regulatory framework that guarantees the quality of the covered assets, certain consistency of their composition over time and hence, the safety and stability of the

[3] EBA report on covered bonds, 20 December 2016

covered bond programmes. This type of requirements offers more level of protection to the investors rather than having covered pools comprised by equal assets.

5. Derivative contracts in the cover pool (Article 11)

Article 11 (2) states that Member States must lay down rules for cover pool derivative contracts to ensure compliance with the requirements under paragraph 1. This includes a proposed limitation on the amount of derivative contracts in the cover pool.

The requirements under Article 11 (1) ensures investor protection and a prudent management of derivative operations. Specifically, Article 11 (1) (a) states that "the derivative contracts are included in the cover pool exclusively for risk hedging purposes."

First of all, it should be necessary to clarify that non-hedging derivative contracts cannot be included in the cover pool. Only certain jurisdictions allow for the inclusion of derivatives inside the cover pool. Therefore Art. 11 should remain as general as possible to this respect. However, where derivatives are not included in the cover pool, but they concur to the coverage ratio, this should be sufficient to ensure the Commission's objectives set out in the Directive. Setting a limit on the derivative contracts in the cover pool could hence imply a limit on hedging capacity. Any limit on derivatives may contradict the benefit of using derivatives for hedging purposes. As this would be negative for the covered bond investor, point (b) in Article 11 (2) ("the limits on the amount of derivative contracts in the cover pool") should be deleted.

6. Segregation of assets in the cover pool (Article 12)

Under paragraph 2, the stipulation of a mandatory asset segregation mechanism would be inconsistent if the issuing institution went into resolution and the applied resolution tool achieved the continuation of the institution as a going concern. We therefore recommend adding at the end of Article 12(2) the restriction 'depending on the applied resolution tool'.

In order to increase legal certainty in this context, we advise complementing this paragraph by recommending Member States earmarking the cover assets either through their registration in cover asset registers or through the transfer of ownership of cover assets to a special purpose vehicle (SPV), depending on the model adopted at the national level.

7. Cover pool monitor (Article 13)

We welcome that cover pool monitoring may be prescribed by national legislation.

Any possible overlaps and reporting obligations to cover pool monitors and public authorities in a Member State should be avoided.

8. Investors information (Article 14)

The possibility that Members States may require the information to be provided to investors on a loan by loan basis - rather typical of securitisations - is unnecessary and very burdensome in the covered bonds market. What's more, investors do not demand this either.

The ECBC's common Harmonised Transparency Template (HTT) demonstrates the commitment of the covered bond issuer community to ensure that investors continue to have access to relevant and up-to-date information.

We therefore believe that current disclosure requirements -CRR and HTT by the ECBC - are sufficiently comprehensive. In our opinion, the requirement should be removed from the text even in the optional form for the Member States in which it appears.

Under Article 14 (2)(c), risk details in relation to credit should be drafted in a more precise way. It obviously refers to loan-to-value risk. Hence, we recommend replacing 'credit' by 'LTV'.

Article 14 also requires coherence with Article 27. There may be a wider disclosure under the European Covered Bond standard. The draft of the Directive stipulates that all bonds secured in EU countries that meet the requirements of the regulatory package will be able to obtain the designation "European Covered Bond" and consequently - at least at the level of perception by investors - will be aligned to meet the standards of the directive.

9. Requirements for coverage (Article 15)

Operational costs: there is uncertainty about the classification of costs as operational costs. The requirement to cover operational costs is not adequate in a directive for covered bonds. In many countries in Europe covered bonds are issued from universal banks and it is not possible to find a verifiable amount to identify as operational costs in these business models. In addition, we would appreciate a clarification that the legally required over-collateralisation automatically covers operational costs. Lastly, we doubt that operational costs can in advance be determined numerically.

In the case of a specialist bank, which was established for the purpose of issuing mortgage bonds, almost all of its activity can be treated as being carried out - as part of the issue program. Therefore, it is not clear exactly what costs should be included in the calculation of the coverage. it is necessary to reword or specify how to understand "costs associated with maintaining the issue program" in the context of the definition "specialized mortgage credit institution".

Accrued interests: We would appreciate a clarification that interest coverage can also be achieved through a net present value calculation and coverage requirement.

Defaulted uncollateralised claims: The wording in par. 1(d) stipulates that any minor default, even induced by technical error, would have as consequence that the entire cover assets have to be deleted from the cover pool. This would be disproportionate. We therefore advise to delete par. 1(d) and to shift its content to the transparency requirements in Art. 14.

Assets relative to over-collateralisation are not different from normal eligible assets. For this reason, overcollateralization should not be included among the coverage assets considered in Article 15.

As the coverage requirement is worded it is unclear what the "nominal principle" means. In Article 16(3) it is also specified that the liquidity reserve should be treated as the reserve in the LCR regulation, that means that the liquidity reserve should be presented at market value. However, that is not in line with the nominal value principle in Article 15(1b). In general, the coverage requirements in both 1(a) and 1(b) need to be more precise. At the same time, it should still be principle based leaving room for the necessary national flexibility while still keeping the high quality of covered bonds.

In the definitions in Article 3(11) substitution assets is defined as "other than the primary assets". Article 15 is not in line with that definition, because there are other assets in the pool except primary and substitution assets. Article 15 is generally unclear and would cause further uncertainty.

10. Requirement for a cover pool liquidity buffer (Article 16)

The liquidity buffer requirement at the cover pool level would increase the funding costs. We consider the buffer requirements excessive, considering elements already in place in other regulation. Firstly, issuers are already subject to strict LCR liquidity buffer requirements, which are calibrated for stressed conditions. Secondly, in the substantial revisions to CRR (CRR2) proposal for net stable funding ratio (NSFR), covered bonds with remaining maturity of less than 6 months will not constitute any available stable funding. Banks need to cover the shortfall with other forms of stable funding. Above all, we think that the calibration of the final NSFR should not penalise secured funding and should not create such cliff effects.

Assets that are eligible collateral for central bank refinancing should be included in the liquidity buffer, because they can be pledged in order to obtain funding to reimburse the covered bonds.

There is also some uncertainty if the liquidity buffers need to be on the balance sheet of the covered bond issuer or if the covered bond issuer can benefit from the liquidity buffers within the group.

The article does not solve the issue with assets in the cover pool being perceived as encumbered when calculating the LCR, which implies a double liquidity requirement for issuers. The legislation should be amended so that is explicitly stated that assets in the cover pool liquidity buffer should be considered unencumbered when calculating liquidity requirements set out in other acts of Union Law. If deemed necessary, the amendment should be implemented via Commission Delegated Regulation (EU) 2015/61.

Otherwise, also in order to avoid concentration risks, it is necessary to allow that exposure to all credit institutions can be eligible for liquidity buffer purposes, without credit quality requirements provided by Article 16 (3)(b). Moreover, banks should be allowed to use for the liquidity buffer purpose assets which are not CRR liquidity requirement eligible.

It is important to understand that liquidity management in a corporate is best handled in a central position for all cash flows in the corporate. Banks are no different. The idea of making certain liquidity reserves for one operation or specific financial instruments among many others is erroneous. It will create sub optimization and hinder a successful liquidity management for an issuer. But, for issuers that have the covered bonds operation as an integrated part of a universal business model this is damaging. So, these requirements of a liquidity reserve will interfere with the banks' liquidity strategies based on CRR. EBF therefore recommends that Article 16 is deleted.

11. Extendable maturity structures (Article 17)

Article 17 of the Directive acknowledges that there are well established market issuances of structures with extension of the maturity date of the covered bonds in the event of predetermined prerequisites. The law in certain MS triggers the soft bullet or pass-through structure at the time of default (as defined in the relevant documentation) of the issuing.

Maturity extension is therefore a means to protect investors by allowing some extra-time (e.g. one year typically for soft bullet structures) to sell portions of the underlying portfolio necessary to reimburse the covered bonds under a default scenario. In addition, it is an important tool for issuers to manage liquidity and re-funding risks. In addition, rating agencies tend to take a positive view of soft bullet structures and, to an even greater degree, of conditional pass-through structures in their rating assessments.

We therefore share the view of the Commission that the use of these structures should not be penalised. Therefore, it should be taken into consideration if a soft bullet structure could replace the possible liquidity buffer requirement in Article 16.

Furthermore, it is unclear how the requirement in article 17(1)(b) should be interpreted, saying "…the maturity extension is not to be triggered at the discretion of the issuer…". We would like this to be clarified.

In order to reduce uncertainty, we see the need to provide a definition of the maturity extension triggers or at least of their underlying parameters. It must be ensured that the exclusion of discretionary powers is confined to the period before the insolvency of the bank. After the insolvency of the issuing institution, discretionary powers of a special administrator will be necessary. Member States should therefore be allowed to stipulate discretionary powers after the opening of the insolvency proceedings and such information should be provided under Article 17 (1)(c)(ii).

Art. 17 appears to apply both in going concern and in insolvency/resolution. It is thus worthconsidering extending legal (non-conditional) premises for extending the maturity date of mortgage bonds also at the stage of normal operation of mortgage banks, as well as in the case of supervisory use of early intervention tools. The specific "final maturity" may change - it is important from the investor's point of view to determine the manner in which it will be designated.

The method of determining the "final maturity of bonds" should be specified, and not the "final maturity" itself.

12. Scope of grandfathering (Article 30)

There is no grandfathering of (i) cover pools (including derivatives) or (ii) covered bond programmes, which are in place when the Directive comes into effect. Article 30 only grandfathers existing covered bonds. There will be a single historical pool which will need to collateralise covered bonds issued under the Directive. Assets (including derivatives) comprised in a pool when the Directive comes into effect should be grandfathered. Covered bond programmes which are established when the Directive comes into effect will have to be approved by competent authorities before any further issues take place which will freeze market issuance, unless they are grandfathered.

We propose the following wording update that in Article 30, in the first line, after "covered bonds issued" insert "and cover assets comprised in cover pools and covered bond programmes established,".

13. Transposition (Article 32)

It is important that the final framework is well thought through and correctly implemented in all the different jurisdictions. This will ensure a successful transition to a harmonized and well-functioning covered bonds market in Europe. To give sufficient time at a national level, the transposition period should be extended to 2 years.

14. Other considerations

In Spain, certain mortgage consumer protection regulations developed by autonomous communities are harming the use of covered bonds or securitisation by requiring lenders to inform clients whether their mortgage loan is included in a cover pool.

To ensure the proper functioning of these debt instruments in future we propose that the Directive should include a binding rule which ensures Member States do not compel covered bonds issuers to communicate to debtors that their mortgage claims have been included in a pool.

Although this possibility could be remote, in those issuance models in which cover assets remain on the issuers' balance sheet, should this trend be replicated in other European Member States it could become problematic for other covered bond issuance models in which loans are transferred to an SPV. This would justify the inclusion of the binding rule in the Directive as proposed above.

Regulation:

1. Article 129 CRR

The proposed amendments to article 129 of the CRR introduce a new requirement on a minimum level of over-collateralisation. This level is set at 2 and 5%, depending on the assets in the cover pool, based on a nominal calculation method.

Even though market aspects, including investors' expectations regarding credit ratings of the covered bonds, may promote higher levels of collateralisation, this may vary case by case depending on the issuers, assets of the cover pool and other factors. Hence, the legislation should aim at providing flexibility to issuers together with sufficient investor protection and leave room for markets to decide whether more collateral is needed in each case, or not.

The EBF proposes to clarify in Art. 129 (1) that derivatives do not fall under exposures to credit institutions according to Art. 129 (1)(c). The purpose of derivatives in the cover pool is protection against interest rate and/or currency risk rather than collateralizing covered bonds. This nature of derivatives is highlighted by Art. 11 of the proposed covered bond Directive stating that "derivative contracts are included in the cover pool exclusively for risk hedging purposes". The intended protection of investors would be at risk, if derivatives were to be included in Art. 129 subparagraph 1 (c) and thus fell under the limits according to the new paragraph 1a. Otherwise, it is necessary to provide that derivative counterparties can qualify without credit quality requirements provided by Article 129. A different provision would restrict the derivative contracts to a limited number of eligible counterparties, paving the way for an unwarranted and unnecessary systemic risk and increasing the all-in cost of the programmes. The Commission refers to the "nominal principle", although the directive includes two assets types (liquidity reserve and derivatives) to market value in its Article 15. Further clarity should be provided on this essential part of the regulation.

Concerning the new provisions on over-collateralisation, we note that public sector lending is not mentioned by the new par. 3a (a). We therefore assume that the assigned low risk weights to public sector loans allow for a level of over-collateralisation of 2% as is the case for residential mortgage lending.

It would be more appropriate to assign the competence to decide on lower minimum levels of overcollateralization to Member States instead of competent authorities. Hence, 'competent authorities' designated pursuant to Article 18(2) of the draft Covered Bond Directive should be replaced by 'Member States'.

Furthermore, is that it is not directly implied that the value of mortgage loans in the collateral register will be taken into account for over-collaterisation calculations, not the loan reduced to 80% (in the context of loans to individuals) and 60% (in the context of commercial loans) property values. We suggest clarifying in the regulation that for the purpose of determining the over-collaterisation, the loan was recognized in full value, and not up to 80% or 60%.