Eba/Op/2024/08

28 October 2024

Opinion of the European Banking Authority on a decision to grant the permission referred to in Article 129(1), point (c)(ii) and Article 129(1a), point (c), of the CRR – notification from the Central Bank of Hungary (MNB)

Introduction and legal basis

1. Article 129 of Regulation (EU) No 575/2013 of the European Parliament and of the Council (CRR)[1], as amended by Regulation (EU) 2019/2160 of the European Parliament and of the Council[2], specifies the conditions that covered bonds shall meet to receive preferential treatment under the prudential framework, and identifies eligible assets that can be used as collateral of those covered bonds.

2. In particular, Article 129(1), point (c), of the CRR specifies that eligible covered bonds can be collateralised by exposures to credit institutions that qualify for credit quality step (CQS) 1 or CQS 2 as specified in Part Three, Title II, Chapter 2 of the CRR. Exposures to institutions that qualify for CQS 3 are allowed to back eligible covered bonds only where those exposures are in the form of: (i) short-term deposits with an original maturity not exceeding 100 days, where used to meet the cover pool liquidity buffer requirement set forth in Article 16 of Directive (EU) 2019/2162 of the European Parliament and of the Council (CBD)[3]; or (ii) derivative contracts that meet the requirements of Article 11(1) of the CBD, where permitted by the competent authorities.

[1] Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26.6. 2013 on prudential requirements for credit institutions and amending Regulation (EU) No 648/2012 (OJ L 176, 27.6.2013, p. 1).

[2] Regulation (EU) 2019/2160 of the European Parliament and of the Council of 27.11.2019 amending Regulation (EU) 575/2013 as regards exposures in the form of covered bonds (OJ L 328, 18.12.2019, p. 1-6).

[3] Directive (EU) 2019/2162 of the European Parliament and of the Council of 27 November 2019 on the issue of covered bonds and covered bond public supervision and amending Directives 2009/65/EC and 2014/59/EU (OJ L 328, 18.12.2019, p. 29).

3. Article 129(1a), point (c), of the CRR specifies that the competent authorities designated pursuant to Article 18(2) of the CBD may, after consulting the EBA, allow exposures to CQS 3 credit institutions in the form of derivative contracts to be used as eligible collateral, provided that significant potential concentration problems in the Member States concerned due to the application of CQS 1 and CQS 2 requirements can be documented. In any case, pursuant to Article 129(1a), point (c), of the CRR, exposures to CQS 3 credit institutions in the form of short-term deposits or derivative contracts must not exceed 8% of the nominal amount of outstanding covered bonds of the issuing credit institution.

4. On 31 October 2023, the Central Bank of Hungary (Magyar Nemzeti Bank – MNB), acting in its capacity of competent authority designated in Hungary for covered bond supervision pursuant to the CBD, consulted the EBA on the exercise of the discretion set forth in Article 129(1a), point (c), of the CRR.

5. The EBA competence to deliver this opinion is based on Article 29(1), point (a), of Regulation (EU) No 1093/2010 of the European Parliament and of the Council[4] (EBA Founding Regulation), and Article 129(1a), point (c), of the CRR, as amended by Regulation (EU) 2019/2160 of the European Parliament and of the Council (CBR), which relates to the EBA's area of competence referred to in Article 1(2) of the EBA Founding Regulation. This opinion has been drafted on the assumption that the information provided to the EBA is correct and that the national framework is aligned with the applicable EU law.

6. In accordance with Article 14(5) of its Rules of Procedure,[5] the EBA's Board of Supervisors has adopted this opinion.

General comments

Having given consideration to:

- the evidence provided by the MNB on the current classification of Hungarian credit institutions in relation to the CQSs assigned on the basis of external credit ratings, whereby no Hungarian credit institution and only seven branches of credit institutions established in other EU Member States or in third countries (of which only four have a business model that is suitable to act as derivatives counterparty) currently classify as CQS 2 or above;

- the evidence provided by the MNB on the current composition of the Hungarian covered bond market and on the characteristics of the Hungarian covered bond regime;

- the evidence provided by MNB on the type and nature of exposures to institutions that covered bonds regularly assume;

[4] Regulation (EU) No 1093/2010 of the European Parliament and of the Council of 24.11.2010 establishing a European Supervisory Authority (European Banking Authority) amending Decision No 716/2009/EC and repealing Commission Decision 2009/78/EC (OJ L 331, 15.12.2010, p. 12).

[5] Decision adopting the Rules of Procedure of the European Banking Authority Board of Supervisors of 11.12.2013 (Decision EBA/DC/001 (Rev 3)).

the EBA is of the opinion that the MNB has provided sufficient evidence to document a significant potential concentration problem in Hungary stemming from the application of the CQS 1 and CQS 2 requirement specified in Article 129(1), point (c), of the CRR. This has the potential to result in prudential concerns and concerns related to the degree of competition in the financial market. The EBA is therefore of the opinion that the exercise of the discretion is adequately justified.

Specific comments

Assessing a significant potential concentration problem

7. The EBA assesses the potential concentration problem within the jurisdiction of the Competent Authority that is notifying its intention to exercise the discretion referred to in Article 129(1a), point (c), of the CRR taking into account several factors, including the following:

    a. the nature and magnitude of exposures of national covered bond programmes to institutions that operate in that jurisdiction, also through branches, and existing exposures to non-domestic institutions, if any;
    b. the number of credit institutions to which a CQS 1 or CQS 2 is being assigned by any of the External Rating Agencies registered with or certified by ESMA (at least by any of the large/internationally active ECAIs);
    c. the scope of business activities of those credit institutions to which a CQS 1 or CQS 2 is being assigned;
    d. other potential specific considerations related to the institutions in that jurisdiction;
    e. potential additional eligibility conditions set by the national covered bond regime on exposures to credit institutions, beyond the CQS 1/CQS 2 criterion;
    f. an assessment of the expected impact of the discretion within that jurisdiction;
    g. other general considerations, where appropriate.

8. In order to determine compliance with Article 129(1a) of the CRR, the EBA considers several different forms of exposures to institutions that may arise within a covered bond programme, including but not limited to the following forms of exposures:

    a. exposures arising from the use of account bank facilities;
    b. exposures arising from derivative contracts entered into with institutions, i.e. where the institution is the counterparty of the covered bond issuer/covered bond programme within the derivative contract;
    c. exposures arising from the use of instruments issued by institutions as substitution/complementary assets within the covered bond programme;
    d. exposures arising from the use of liquidity facilities.

The concentration problem in Hungary

9. Based on the evidence provided by the MNB, the Hungarian covered bond market amounts to € 5.47 bn (nominal amount of outstanding covered bonds), issued by the following 5 banks: Erste Jelzálogbank Zrt.; K&H Bank Jelzálogbank Zrt.; MBH Jelzálogbank Nyrt.; OTP Jelzálogbank Zrt.; UniCredit Jelzálogbank Zrt.[6]

10. As regard to the size of collateral assets, the total cover pools for Hungarian covered bonds amount to € 12.27 bn.[7] As of 31 December 2023, there are no reported exposures to derivative assets in the cover pool. At present, only one bank (OTP Jelzálogbank Zrt.) issued a new FX tranche and produced the derivative contract, but it is not part of the cover pool yet.

11. Issuers do not include uncovered exposures to credit institutions in the cover pool. This extends to assets held for settlement or LCR purposes. They take an unsecured loan and use it for repo to get government bonds to include them in the cover pool.

12. Most issuers (except the most significant one) make no direct lending to customers: the commercial banks lend to customers, while covered bond issuers (mortgage banks) provide instead refinancing loans for commercial banks. Bondholders have then recourse against mortgage bank, commercial bank, and underlying assets. As a consequence, the main items in the cover pool are claims from credit institutions secured by residential real estate claims (which means that they are only indirectly exposed to credit institutions). From a legal point of view, commercial banks guarantee segregation of the cover pool assets at the establishment of the refinancing contract with the mortgage bank.

13. In the recent years the MNB introduced a covered bond purchasing programme for monetary policy purposes. At the same time, the FX bonds issued previously already matured or had been bought back by the issuers. This is why issuers mainly hold government bonds for liquidity issues, and they have no FX exposures in the cover pool to hedge with derivatives, nor exposures to credit institutions. All current bonds are denominated in domestic currency (HUF).

14. However, following monetary tightening, the MNB's purchasing programme has been revoked, which means that banks have to seek for new investors elsewhere. Tapping the EU's capital market requires issuing FX hedged bonds, making the use of derivatives necessary to hedge again currency risk. In addition, the Hungarian national covered bond regime requires issuers to hedge the foreign exchange open positions. Evidence from the MNB indicates that before 2008 multiple mortgage banks had FX covered bonds, so there is a potential to issue FX bonds again.

15. As regard to the credit rating of Hungarian banks, out of the nine Hungarian banks with available long-term credit rating, none has an external credit rating qualifying for either CQS 1 or CQS 2 (see also Table 1 below). Generally, the credit rating of Hungarian banks/groups is capped by the country ceiling of Hungarian sovereign debt rating (which corresponds to CQS 3).

[6] Data as of 31 December 2023, source MNB.

[7] Data as of 31 December 2023, source MNB.

Table 1 – Hungarian credit institutions with long term credit rating and corresponding credit quality step (as of December 2023)

Credit institution	Best LT rating	Credit quality step
CIB Bank Zrt.	BBB (Fitch)	3
ERSTE BANK HUNGARY Zrt.	Baa1 (Moody's)	3
Eximbank Zrt.	BBB (S&P)	3
K&H Bank Zrt.	Baa1 (Moody's)	3
MBH Bank Nyrt.	Baa2 (Moody's)	3
MFB Zrt.	Baa2 (Moody's)	3
OTP Bank Nyrt.	Baa1 (Moody's)	3
OTP Jelzálogbank Zrt.	Baa1 (Moody's)	3
Raiffeisen Bank Zrt.	Baa1 (Moody's)	3

16. According to the data provided by the MNB, should the discretion not be exercised, no Hungarian-based legal entity would be eligible as a derivative counterparty for Hungarian covered bond issuers. This may negatively affect the market efficiency in terms of costs, volumes, and market continuity.

17. The EBA has additionally assessed whether branches of non-Hungarian credit institutions established in other EU Member States or third countries and operating in Hungary could act as eligible derivative counterparties. Table 2 provides information on the branches of credit institutions established in other EU Member States or third countries operating in Hungary with an external credit rating.

Table 2 –Credit institutions established in other EU Member States of third countries operating in Hungary via branch with available long term credit rating (as of December 2023)

Credit institution	Best LT rating	Credit quality step
Bank of China Limited Mo-i Fióktelepe	A (S&P)	3
BNP Paribas Magyarországi Fióktelepe	Aa3 (Moody's)	1
China Construction Bank (Europe) S.A. Magyarországi Fióktelepe	A1 (Moody's)	2
Citibank Europe plc. Fióktelepe	Aa3 (Moody's)	1-2
Deutsche Bank AG Magyarországi Fióktelep	A1 (Moody's)	2
HYPO-BANK BURGENLAND AG Magyarországi Fióktelepe	A1 (Moody's)	2
ING Bank N.V. Magyarországi Fióktelepe	Aa3 (Moody's)	1
Oberbank AG Magyarországi Fióktelep	A (Fitch)	2

18. As reported in Table 2, out of the eight foreign branches with available long term rating, seven qualify for CQS above 3. Four of these branches (BNP Paribas Magyarországi Fióktelepe; Citibank Europe plc. Fióktelepe; Deutsche Bank AG Magyarországi Fióktelep; ING Bank N.V. Magyarországi Fióktelepe) are theoretically entitled to provide services as derivative counterparties given their business model and their CQS.

19. According to the information provided by the MNB, there are currently no existing cases of non-domestic derivative counterparties for which a coverage asset swap is in place, and there is no

indication that they would be able or have willingness to provide such services, especially given the limits on FX operations imposed by their internal business practices – in addition to the legal requirements – and the high volatility of the Hungarian Forint. In addition, it should be noted that branches have generally a reduced operating capacity compared to standalone banks.

20. Given the difficulties to find FX counterparties at a reasonable cost, relying on non-domestic derivative counterparties for risk hedging in covered bond programmes is not a current market practice in Hungary. Therefore, there is a risk that a sudden pressure towards a reliance on non-domestic counterparties may have an impact on the costs for the covered bonds programmes and hence the costs of funding for banks.

21. Finally, according to the information provided by the MNB gathering opinions from the industry, should a waiver be granted, mortgage banks would also consider reviving the market for derivative contracts in local currency such as interest rate swaps (which would make easier to find partners due to the lower risk level).

22. It should be noted that:

    a. the documented size of the Hungarian covered bond market; and

    b. each issuing institution, in accordance with Article 129 of the CRR, may collateralise with exposures to credit institutions up to 15% of its outstanding covered bonds,

23. Consequently, the potential exposure of all Hungarian covered bond issuers to only four branches of credit institutions established in other EU Member States and operating in Hungary as eligible hedging derivatives counterparties is, in the view of the EBA, likely to result in an excessive concentration and, consequently, to pose both prudential concerns and concerns related to the degree of competition in the Hungarian financial market.

Exercise of the discretion

24. “The EBA understands that the CBD has been transposed into the Hungarian regulatory framework through Act XXX of 1997 on Mortgage Loan Companies and on Mortgage Bonds, which enables to include derivatives with credit quality step 3 partners into the cover pool. The competent authority’s approval of this waiver does not need to be reflected in the Hungarian law. It will be announced transparently, disclosed as CBD Article 26 paragraph 1 (a), and it is applicable directly in the calculation of coverage assets.”

Review of the permission’s continued relevance

25. Should the MNB verify that, in the future, concentration problems disappear, an amendment to the provisions of the waiver would be required to exclude the admissibility of derivatives whose counterparties qualify for CQS 3 to the collateral pools of covered bonds. The amendment would then also indicate what the consequences would be with respect to existing derivatives entered into with CQS 3 counterparties. In this respect, the need for a specific grandfathering regime, as

well as its features (including its length and conditions), would be assessed in due time, also depending on the expected impact that this amendment would have on existing covered bond programmes.

26. This opinion will be published on the EBA's website.

Done at Paris, 28 October 2024

[signed]

José Manuel Campa

Chairperson
For the Board of Supervisors