ECBC
European Covered Bond Council
The Covered Bond Voice of the European Mortgage Federation

ECBC Response to the European Supervisory Authorities Consultation Paper on Draft Regulatory Technical Standards on risk-mitigation techniques for OTC-derivative contracts not cleared by a CCP under Article 11(15) of Regulation (EU) No 648/2012

Brussels, 14 July 2014

The European Covered Bond Council (ECBC)[1] represents the covered bond industry, bringing together covered bond issuers, analysts, investment bankers, rating agencies and a wide range of interested stakeholders. The ECBC was launched by the European Mortgage Federation (EMF) to promote the interests of covered bond market participants at international level. As of July 2014, the ECBC brings together over 100 members from more than 25 active covered bond jurisdictions representing over 95% of the €2.81 trillion outstanding covered bonds.

The ECBC welcomes the opportunity to respond to the consultation launched by the European Banking Authority (EBA), the European Insurance and Occupational Pensions Authority (EIOPA) and the European Securities and Markets Authority (ESMA) on 14 April 2014 on risk-mitigation techniques for OTC-derivative contracts not cleared by a CCP under Article 11(15) of Regulation (EU) No 648/2012, which outlines the framework of the European Market Infrastructure Regulation (EMIR). The ECBC would also like to thank the European Supervisory Authorities (ESAs) for their ongoing commitment to a constructive dialogue.

The sections of the consultation which focus on the treatment of covered bond derivatives have been thoroughly discussed within the ECBC technical working groups and we would like to share some observations with you. Prior to specifically answering the question posed, we would like to provide you with a more in-depth analysis of certain issues raised in the consultation.

1. Introduction

By way of background, covered bonds are dual recourse debt instruments issued by credit institutions (the covered bond issuer) and secured by a cover pool of financial assets, typically composed of mortgage loans or public-sector debt. For over 200 years, covered bonds have proved to be an efficient debt instrument enabling banks to mobilise private sector means and capital towards long-term investment with a wide public benefit and, in particular, housing loans and public sector debt. They have also been, during the recent financial turmoil, one of the only asset classes able to restore investor confidence and to ensure access to debt capital markets for European issuers.

The ECBC is supportive of the goal of improving the resilience, transparency and efficiency of the OTC derivatives market and, in particular, welcomes the efforts of the European Institutions to take into

[1] The European Covered Bond Council is registered in the European Institutions' Transparency Register under European Mortgage Federation ID Number 24967486965-09.

account the specificities of covered bonds. In Recitals 16[2] and 24[3], European regulators have indeed considered that two specificities should be taken into consideration when establishing the draft technical implementation measures:

- The specific provisions of covered bonds' legal frameworks that would make OTC derivatives, which are used to hedge interest rate and/or currency risk within covered bond programmes (referred to herein as "covered bond derivatives"), ineligible for clearing through a Central Clearing Counterparty (due to, among other reasons, the fact that the derivative is designed to survive the insolvency of the issuing institution, whereas the standardised documentation requires that all derivatives be closed out at the time of an issuer's insolvency).
- The fact that in many jurisdictions collateral posting is unilateral (as dictated by covered bond legal frameworks and rating agency criteria) - i.e. the issuer does not post collateral, whereas the counterparty does, when required.

Covered bond legislation is specifically designed to protect the market against financial turmoil. Therefore, we welcome the fact that the ESAs have acknowledged the special features of covered bond-related derivatives and allowed for such derivatives to be excluded from bilateral collateral posting of initial and variation margins, while ensuring the derivative counterparties a degree of protection by outlining specific conditions that have to be met.

The justification for an exemption of covered bond derivatives from collateral posting, lies in legal and technical provisions that impede the central clearing of such derivative transactions. We believe that such a technical exclusion would not increase the risk profile of these derivatives. Therefore, they should not be compensated by higher risk-weightings, which would add an unnecessary financial burden on this asset class which has been vital for the European banking industry, notably during the financial turmoil.

We would like to draw your attention to a number of issues that we believe should also be taken into account in the final regulatory technical standards (RTS) which implement paragraph 15 of Article 11 of Regulation (EU) No 648/2012 before analysing in-depth in Section 2 the issues raised in the Consultation Paper:

- Derivatives that satisfy the requirements in Article 3 GEN and that are therefore excluded from the bilateral collateral posting of initial and variation margins, due to their special features, should also be excluded when calculating the group thresholds for non-centrally cleared derivatives in Article 1 FP "Final provisions".

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[2] "[...] *In determining the subjection to the clearing obligation of classes of derivatives, ESMA shall take into account the specific nature of OTC derivatives which are concluded with covered bond issuers or with cover pools for covered bonds",* Recital 16

[3] "[...] *When developing technical standards to specify the arrangements required for the compliance to accurate and appropriate exchange of collateral to manage risks associated with uncleared trades, ESMA shall duly take into account impediments faced by covered bond issuers or cover pools in providing collateral in a number of EU jurisdictions. ESMA shall also take into account the fact that preferential claims given to covered bond issuers counterparties on the covered bond issuer's assets provides equivalent protection against counterparty credit risk",* Recital 24.

The unilateral posting is an inherent feature of covered bonds and, thus, cannot be reduced over time. However, the group thresholds, which differentiate the entities that can be exempt from the initial margin requirements, will be decreasing until December 2019, when any counterparty belonging to a group whose aggregate month-end average notional amount of non-centrally cleared derivatives exceeds EUR 8 billion will be subject to the margin requirements. This seems to unfairly treat financial groups with covered bond issuers, as the group cannot reduce their covered bond related derivatives by way of centrally clearing, i.e. covered bond derivatives which are ineligible for clearing through a Central Clearing Counterparty.

Furthermore, since the covered bond derivatives referred to in Article 3 GEN are used for hedging purposes of the cover pool, the risk of the financial group would not be increased if such derivatives are excluded from the group thresholds calculation. If the covered bond derivatives are not excluded from the group threshold calculation this would also contravene the general principle of proportionality, since a small group that would be below the EUR 8 billion threshold if covered bond derivatives are excluded from the threshold calculation might be above this threshold merely because the covered bond derivatives are included, and therefore subject to the initial margin posting requirements even if it would otherwise be exempted.

- The covered bond issuer's derivative counterparty, according to the draft RTS, should post collateral as initial margin, even if the covered bond issuer's derivatives are excluded from bilateral collateral posting of initial and variation margins. This collected collateral must be segregated from proprietary assets on the books and records of a third party holder or custodian, or via other legally effective arrangements made by the collecting counterparty based on Article 1 SEG "Segregation of initial margins". Indeed, there should be segregation arrangements in place that give the covered bond issuer's derivative counterparty sufficient protection if the covered bond issuer enters into bankruptcy or other insolvency proceedings. Moreover, in Article 1 REU – "Treatment of collected initial margins" it is stipulated that the collecting counterparty, i.e. the covered bond issuer, should not re-hypothecate, re-pledge or otherwise re-use the collateral collected as initial margin.

These various conditions and requirements are impossible or at least extremely problematic to comply with in many covered bond jurisdictions given the fact that when the covered bond issuer receives the initial margin, it legally must be registered as part of the cover pool assets and, hence, it is no longer "segregated" from the rest of the pool in the case of the insolvency of the issuer. The collateral would, following the legal requirement to register the derivatives used for hedging purposes in the cover pool register, including the transactions under the derivative agreements and the received collateral thereunder, form part of the cover pool. Therefore, the collateral cannot be individually segregated under many covered bond legislations since it forms part of the assets in the cover pool. In addition, the requirement that the collateral not being re-used might in itself contravene national covered bond legislation since the collateral will form part of the cover pool and as such be considered as "re-used".

In this context it should also be noted that the requirements on the swap counterparty in a covered bond swap are higher and stricter than in a normal derivative transaction. In the current practices in the market there are contractual requirements on the counterparty in terms of collateral triggers, volatility buffers (i.e. that there is a buffer added when calculating the collateral that the counterparty must post if the credit rating of the counterparty is below certain levels) and replacement triggers if the credit rating of the counterparty falls below certain levels. These requirements on the counterparty give an extra protection for the covered bond issuer and the covered bond holders if the credit quality of the swap counterparty is reduced below a certain level, in effect similar to what the initial margin aims to achieve and is different from the normal practices for non-cleared swaps. Therefore, we consider the initial margin requirement to be redundant in a covered bond swap context and we propose that derivatives to a covered bond issuer are excluded from the initial margin requirement.

In addition, if the requirement for posting initial margin would remain for a covered bond issuer's derivative counterparty there is often no need for such initial margin to be segregated. The purpose of the segregation requirement is to protect the collateral provider in the event that the collateral receiver is declared bankrupt. On the condition that a covered bond legislation gives the collateral provider a prioritized claim on the covered bond issuer (which ranks at least *pari passu* with the covered bond claims) for return of the initial margin collateral, we consider it unnecessary to require a segregation of such initial margin collateral from other assets of the covered bond issuer. In fact, such prioritized claim on the covered bond issuer is in most instances a better protection for the collateral provider than a segregation requirement, since the risk associated with a segregated cash account held with a third party institution is typically commensurate with an unsecured claim on such third party institution (which in turn is typically a worse risk than a prioritized claim on a covered bond issuer).

- The legislation referred to in paragraph 1(e) of Article 3 GEN "Treatment of derivatives associated to covered bonds programmes for hedging purposes" should be modified from "Regulation (EU) No 574/2013" to "Regulation (EU) No 575/2013".

- The draft impact assessment on page 60 of the Consultation Paper seems to be missing paragraph (c) of Article 3 GEN "Treatment of derivatives associated to covered bonds programmes for hedging purposes".

2. General Comments

1) Requirement of continuation of the derivatives after default

Covered bond legal frameworks make OTC derivatives, which are used to hedge interest rate and/or currency risk within covered bond programmes, ineligible for clearing through a Central Clearing Counterparty (CCP) due to, among other reasons, the fact that the derivative is designed to survive the insolvency of the covered bond issuer. In the event of the covered bond issuer's default, the source of payment switches to the cover pool, on which the derivative counterparty has a preferential claim alongside with the covered bond investors.

Derivatives in a cover pool are used to make payments from borrowers match the payments to the bondholders, if the bond payments and loan payments do not completely match. For instance, derivatives can be used, if the liabilities of the programme are predominantly fixed rate while the underlying cover pool assets pay a floating rate of interest. Therefore, derivatives are used to hedge the risks in the cover pool. This protects bondholders and helps ensure that payments to bondholders are timely and in the correct amount.

Against this background, it is important that the requirement in paragraph 1(a) of Article 3 GEN is limited to *insolvency related* defaults only. As presently drafted, no event of default relating to the issuer would be permitted. Such a requirement would be incompatible with market practice and in conflict with the requirements applied by the rating agencies for AAA compliant covered bond-related derivatives.

Care should also be taken to account for certain technicalities of covered bond derivatives that differ from plain vanilla swaps:

- Swap counterparties active in the covered bond market recognise that their *pari passu* claim on high quality cover assets and protections provided by the legal framework offset the risk of unilateral posting.
- Standby swaps work in a particular manner in which the issuer provides a swap to the cover pool, but upon an issuer default, the standby provider takes over. These structures should not be penalised.

The purpose of this restriction should be to avoid that the derivative is terminated as a result of the issuer's insolvency, not to prevent the counterparty from terminating upon other limited non-insolvency- related defaults. Therefore, we would propose to add the words "insolvency-related" before "default" in paragraph 1(a) of Article 3 GEN.

2) Use of an EU-harmonised classification of covered bonds

We support the idea of using an EU-harmonised classification of covered bonds as it ensures adequate and equal privileges for this class of financial instruments.

Indeed, the success of covered bonds in Europe lies in the Industry's capacity to respond to the challenges of the current crisis, its ability to share best market practices - thereby allowing the continuous fine-tuning of European covered bond legislation, and helping to significantly increase the transparency and harmonisation of the asset class. An example of this is the launch, in January 2013, of the Covered Bond Label initiative which, in line with the European Commission's and the European Central Bank's calls for further harmonisation, aims at responding to the request for improved standards and increased transparency at European level. The Covered Bond Label facilitates access to relevant and comprehensive information at bond, pool, issuer and legal framework levels and facilitates comparisons at jurisdiction level through transparency disclosures and common definitions.

Since 1 January 2014, the Covered Bond Label Convention, which defines the core characteristics required for a covered bond programme to qualify for the Label, was amended to require compliance with Article 129 of the Capital Requirements Regulation (CRR – Regulation (EU) No 575/2013). Therefore, the fact that paragraph 1(e) of Article 3 GEN refers to this same regulation indeed is in line with the changes undertaken by the covered bond Industry through this market initiative.

However, we would prefer to link the conditions to covered bonds issued in accordance with Article 52(4) of the Directive 2009/65/EC (UCITS). There are covered bonds in Europe which are based on a very strong legal framework, offer a high quality and credit protection for investors, enjoy a strong special public supervision, fulfil generally the same conditions as Art. 129 CRR compliant covered bonds, but are backed by assets that are not listed in Art. 129 CRR. Above all, these covered bonds offer the swap counterpart the same credit protection than covered bonds compliant with Art. 129 CRR, as liabilities stemming from derivatives in the cover pool must be covered at all times by law. The counterparty has a preferential claim on the cover pool, ranking *pari passu* with the covered bond holders, which fully compensates the necessity to collect collateral in order to mitigate the counterparty risk. In addition, also for these covered bonds the national laws do not allow posting collateral from the cover pool.

The high credit quality of these covered bonds is recognised by regulators in exempting UCITS compliant covered bond programmes from the bail-in regulations in accordance with the Bank Recovery and Resolution Directive (BRRD). Therefore we suggest that the classification of EU-harmonised covered bonds is based on the UCITS definition of covered bonds.

3) Overcollateralization requirement

The ECBC supports the view that covered bond programmes should be subject to a minimum overcollateralization (OC) requirement. Although this capital is costly, an OC requirement will increase the probability that a cover pool is able to honour its obligations. Setting the levels is, however, a trade-off between lending capabilities (and growth) and security/capital.

Currently, not all jurisdictions are aligned to a legal OC of at least 2%, nevertheless, this does not necessarily translate to differences in cover pool quality. Therefore, we would suggest the ESAs to consider the requirement on a "legal OC" to include either a minimum regulatory OC or a minimum contractual OC. Furthermore, considering the timing implications if the various national covered bond legislations need to be amended to include a minimum OC, we would strongly suggest a grandfathering period before this requirement becomes mandatory.

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Given that the discussion of OC is taking place in parallel in different regulatory files, we would also encourage the ESAs to set the same minimum requirement across the board, for example in the requirements in certain liquidity classes under the Liquidity Coverage Requirement (LCR).

4) Current practices of one-way collateral requirements

The cover pools are constructed so that no stakeholder obtains a preferential treatment in priority to the covered bondholders. This is done in order to ensure the protection of the covered bond investors. Nevertheless, the counterparty has a *pari passu* claim on the assets in the cover pool and the high level of transparency on the construction of covered bond cover pools makes it possible for such a counterparty to get a complete overview and, hence, evaluate the risk exposure.

In terms of current practices of one-way collateral requirements, most, but not all, covered bond derivatives are structured to comply with rating agency requirements, which include:

- One-way CSA in favour of the cover pool for the MTM (variation margin) and a volatility buffer (conceptually similar to an initial margin), with limited collateral eligibility.
- Triggers for when collateral is actually posted by the counterparty. This is an important issue as highly rated counterparties are, therefore, often not required to post collateral to the cover pool (unless subsequently downgraded[4]). This is something which is not addressed in the current proposal.
- Replacement triggers: upon the loss of certain threshold ratings, counterparties are required to replace themselves or provide a guarantor, offering further protection to cover pools.

5) Assessment of the technical options (page 59-60): Comments on Alternative 1 (one-way margin requirement) versus Alternative 2 (collateral provider)

Although the existing model with one-way collateral requirement is the best solution, Alternative 1 seems the most sensible way to proceed. Alternative 1 is necessary for the covered bond industry to function and should, therefore, not be removed. However, the current practice with one-way margining should also be maintained for covered bonds.

While setting technical standards on alternative risk-mitigation techniques is a positive step, it is difficult to see the value added of Alternative 2 unless the third-party is a Central Clearing Counterparty (CCP) or a central bank. Risk is simply transferred to the third-party, which brings risk to the cover pool. In addition, the third party would introduce an additional counterparty risk element (e.g. it could default).

For the above reasons, in our view, the Alternative 2 does not reduce risk but, rather, it enhances risk and we would, therefore, be supportive of Alternative 1.

[4] In some jurisdictions, counterparties may require posting even before rating agency triggers are hit subject to thresholds.

6) Requirement on the derivative counterparty ranking

Ranking as regards to the Back to Back Swaps

The hedging of the foreign exchange (FX) and interest rate (IR) mismatch between the assets and the covered bonds often (particularly for specialised issuers) remains managed in the balance sheet of the originator/parent of the specialised issuer (especially in the case of contingent swaps). Only when certain rating triggers are breached, are the swaps activated at the issuer level, i.e. front swaps. In these cases there is no mismatch of FX and IR risk at the issuer level, as the features of covered bonds are matched by the secured loan that the issuer provides to the originator/parent.

In order to mitigate and neutralise the mismatch created at the issuer level due to the activation of the front swaps, so-called "Back to Back Swaps" are put in place with the originator/parent. The Back to Back Swaps rank subordinate to the front swaps and the covered bond holders.

To allow these Back to Back Swaps to be cleared centrally and fulfil the other conditions of the Article 3 GEN, the same exemption as for the front swaps should apply.

3. Consultation Question on Covered Bonds

Does the proposal adequately address the risks and concerns of counterparties to derivatives in cover pools or should the requirements be further tightened? Are the requirements, such as the use of the CRR instead of a UCITS definition of covered bonds, necessary ones to address the risks adequately? Is the market-based solution as outlined in cost-benefit analysis section, e.g. where a third party would post the collateral on behalf of the covered bond issuer/cover pool, an adequate and feasible alternative for covered bonds which do not meet the conditions mentioned in the proposed technical standards? (page 27)

Please find below a short summary of the ECBC response to the issues raised in Question 3 of the Consultation Paper.

The ECBC welcomes the fact that the ESAs have acknowledged the special features of covered bond-related derivatives and allowed for such derivatives to be excluded bilateral collateral posting of initial and variation margins, while ensuring the derivative counterparties a degree of protection by outlining specific conditions that have to be met.

We consider that the proposal adequately addresses the risks faced by a counterparty to a covered bond issuer/cover pool default and that, overall, the requirements specified in paragraph 1 of Article 3 GEN are necessary for the mitigation of such risks (see Sections 2.1-2.3 above). In particular, we support the idea of using an EU-harmonised classification of covered bonds, as it ensures equal privileges for this class of financial instruments. However, as covered bonds which are based on strong national legal frameworks and fulfil Art. 52 (4) UCITS but whose cover assets are not listed in Art. 129 CRR offer the same credit protection to swap counterparts, we suggest that the classification of covered bonds should be based on Art. 52 (4) UCITS (see Section 2.2 above).

We agree with the view that covered bond programmes should be subject to a minimum overcollateralization requirement, although we would encourage the ESAs to set the same minimum requirement across the different regulatory files that are currently addressing this topic. In addition, considering the timing implications if the various national covered bond legislations need to be amended to include a minimum OC, we would strongly suggest a grandfathering period before this requirement becomes mandatory (see Section 2.3 above).

There are a number of other issues that the ECBC would also like to invite the ESAs to take into consideration. In the first place, we would propose to add the words “insolvency-related” before “default” in paragraph 1(a) of Article 3 GEN. It is important that this requirement is limited to *insolvency related* defaults only, as the purpose of this restriction should be to avoid that the derivative is terminated as a result of the issuer’s insolvency, not to prevent the counterparty from terminating upon other limited non-insolvency- related defaults (see Section 2.1 above). Moreover, the scope of the contemplated carve out regime to the benefit of covered bonds should be broadened in order to take into account issues raised by bespoke derivatives performed for hedging purposes, such as Back to Back Swaps (see Section 2.6 ii above).

Furthermore, we believe that derivatives that satisfy the requirements in Article 3 GEN and that are, therefore, excluded from the bilateral collateral posting of initial and variation margins, due to their

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special features, should be also excluded when calculating the group thresholds for non-centrally cleared derivatives in Article 1 FP "Final provisions". The unilateral posting is an inherent feature of covered bonds and, thus, cannot be reduced over time (see Section 1 above).

In addition, the relief for covered bond derivatives should be two-way, i.e. also apply to covered bond derivative counterparties. The collected collateral must be segregated based on Article 1 SEG "Segregation of initial margins" so that the covered bond issuer's derivative counterparty has sufficient protection if the covered bond issuer enters into bankruptcy or other insolvency proceedings. However, in Article 1 REU – "Treatment of collected initial margins" it is stipulated that the collecting counterparty, i.e. the covered bond issuer, should not re-hypothecate, re-pledge or otherwise re-use the collateral collected as initial margin. These various conditions and requirements are impossible or at least extremely problematic to comply with in many covered bond jurisdictions given the fact that when the covered bond issuer receives the initial margin, it legally must be registered as part of the cover pool assets and, hence, it is no longer "segregated" from the rest of the pool in the case of the insolvency of the issuer. Moreover, we consider the segregation of such initial margin collateral from other assets of the covered bond issuer unnecessary when a covered bond legislation gives the collateral provider a prioritized claim on the covered bond issuer. The risk associated with a segregated cash account held with a third party institution is typically commensurate with an unsecured claim on such third party institution which, in turn, is typically a worse risk than a prioritized claim on a covered bond issuer (see Section 1 above).

Finally, with regard to the Alternatives proposed on pages 59 and 60, we would like to highlight that Alternative 1 (one-way margin requirement) seems to be the most sensible way to proceed, although the current practice with the one-way margining should also be maintained. The market-based solution (Alternative 2), as outlined in the cost-benefit analysis section of the ESAs Consultation Paper, is not a particularly adequate alternative for covered bonds, as it represents a transfer of risks to a third-party which then brings additional counterparty risks to the cover pool (see Sections 2.4-2.5 above).

The ECBC stands ready to assist the ESAs in its role of market catalyst and think-tank. We very much hope that you will take our remarks into consideration. Please, do not hesitate to contact us, if we can be of any assistance or if you would like further clarification or elaboration on our views.

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