

ECBC Response to the Basel Committee on Banking Supervision's Consultative Document Entitled "International framework for liquidity risk measurement, standards and monitoring"

Brussels, 16 April 2010

Executive Summary

The European Covered Bond Council (ECBC), representing the interests of the €2.4 trillion covered bond asset class, welcomes the opportunity to comment on the Basel Committee on Banking Supervision's Consultation on strengthening capital and liquidity regulations in the banking sector.

We would like to take the opportunity to contribute towards the Basel Committee's goal of promoting a more resilient banking sector by providing the following comments:

1. The fundamental characteristics of covered bonds strongly support their inclusion in the narrow definition of highly liquid assets.
2. Evidence does not support the same treatment for covered bonds as for corporate bonds. Covered bonds offer a dual recourse to both the issuing bank and a well defined pool of high quality assets. Further the asset class is regulated by law and subject to specific supervision. Market volumes for highly rated covered bonds very largely exceed those of corporate bonds and even government bonds in several countries. For example, 100% of covered bonds included in the iBoxx € Covered Bond Index are rated at least AA, compared to just 4% of the iBoxx non-financial index, a proxy for corporate bonds.
3. Covered bonds exhibit a much closer performance with government bonds, for example, in terms of credit quality.
4. This suggests that the suggested haircuts of 20% or 40% are completely inappropriate for covered bonds. Indeed, covered bonds have an excellent track record, better ratings stability and default history than some government securities. These haircuts would make it almost impossible to see covered bonds being used meaningfully for the purposes of the LCR on economic grounds.
5. We would encourage that central banks be involved both in defining liquid assets and setting appropriate haircut levels, given their significant experience in evaluating the credit and liquidity risk of bonds, including covered bonds.
6. We would also like to rise several areas where the proposals as set forward in the Consultation could be improved to better take into account both the specificities of the covered bond market and more closely align the results of this exercise with the goal of promoting a more resilient banking sector:
 - a. Under the current proposals, banks would be penalised for holding their own covered bonds, however, banks frequently acquire their own covered bonds as part of their ALM management and to improve the overall liquidity of their bonds. This type of market-making by the issuer itself is not typically observed in either the corporate or government bond markets.

- b. The maturity of the bonds should be taken into account for the haircut of highly liquid assets, as is standard practice in central banks' repo policy.
- c. The proposals introduce rating triggers which are different for different asset classes. Also jump levels are introduced by supervision through strict market measurement, which as the current crisis has shown, creates instability in the banking sector.
- d. Further specification of the conditions banks would eventually be able to make use of liquidity buffer assets are necessary to ensure the rules operate effectively.
- e. Concerning the role of covered bonds as a funding instrument, the non-recognition of securities with less than one year to maturity in the NSFR poses a serious problem for banks, particularly those which use a matched funding strategy. Additionally, the proposals do not appear to take into account the specificities of either banks operating under the special bank principle, or subsidiaries within a banking group.

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Introduction

The European Covered Bond Council (ECBC) welcomes the opportunity to comment on the Basel Committee's consultative document titled "International framework for liquidity risk measurement, standards and monitoring". We consider the Basel Committee to be appropriately placed to tackle the issue of improving the liquidity standards of the banking industry in general, thereby ensuring a coherent global response. We therefore welcome the effort within the Basel process to further improve the level playing field for the banking industry on a global scale.

The ECBC 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 created by the European Mortgage Federation (EMF) in 2004 to represent and promote the interests of covered bond market participants at the international level. As of April 2010, the ECBC has over 100 members from more than 20 active covered bonds jurisdictions. ECBC members represent over 95% of €2.4 trillion covered bonds outstanding.

With regard to liquidity considerations and the proposals on highly liquid assets, we would like to stress that the position of the Basel Committee towards covered bonds does not yet adequately reflect the underlying credit quality of this particular asset class as well the regulatory advantages which these bonds currently receive from banking supervisory authorities and central banks throughout the world. For example, the equal treatment of corporate bonds and covered bonds only very insufficiently catches the underlying economic realities like tradability within these two segments, standardisation, additional legal protection or credit quality. We will elaborate on these points in more detail in this paper.

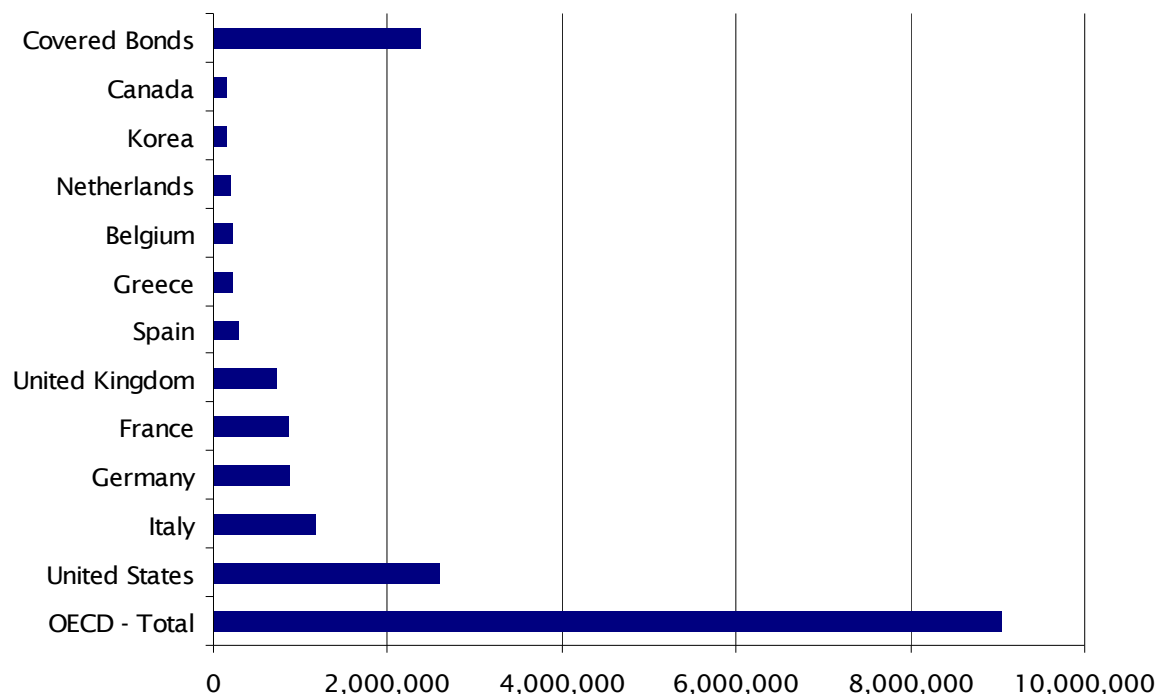
The Basel Committee is currently considering, whether to implement a narrow or a somewhat broader definition of highly liquid asset (see page 10, bullet point 29). We understand that the selection of the narrow definition of liquid assets would automatically exclude covered bonds from the possibility of being recognised as highly liquid assets on a bank's balance sheet.

We strongly argue in favour of the inclusion of covered bonds in the narrow definition of highly liquid assets.

Firstly, covered bonds form the second largest bond market in the world, second only to the US government bond market (Chart 1). By not including this important asset class in the narrow definition of liquidity buffers, we fear that banks will be severely restricted in their ability to construct a well balanced and diversified portfolio of liquid assets, which would run counter to the objectives of the Basel Committee.

Chart 1: Volume of selected OECD Government Bond Markets end of 2008

Source: OECD, ECBC, LBBW



Secondly, banks have been and still are traditional investors in covered bonds especially in the Jumbo segment of the covered bond market for treasury/liquidity operations, underpinning the market depth of this segment. It is important to point out that covered bonds in certain jurisdictions represent greater depth and liquidity than the government bond sector because of limited government debt. In such cases covered bonds become a key trading and investment product. The fact that covered bonds represent private sector issuers should not discriminate it from being eligible as highly liquid assets. The determining factor should be market functionality rather than issuer categorisation.

Chart 2: Volume of Euro denominated long term bond markets by sector in €bn
 Source: ECB, LBBW

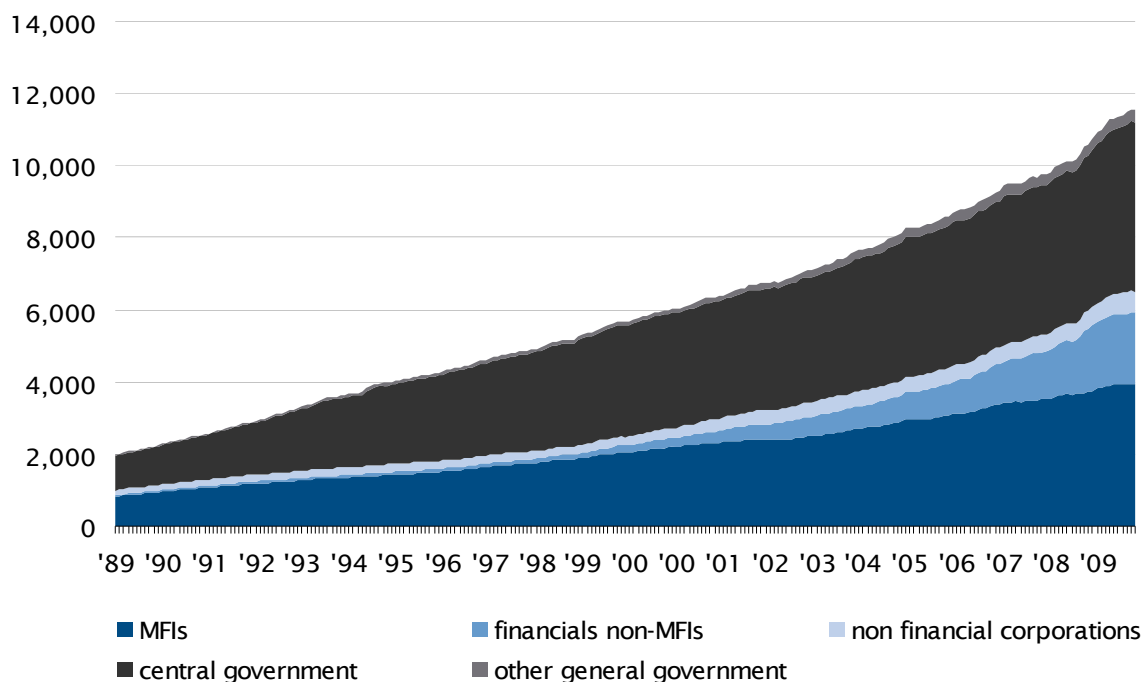
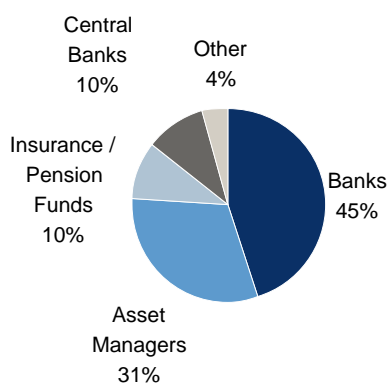


Chart 3: Distribution of order books in Covered Bond Benchmark issues in the international market 2006 until 2010 YTD by type of investor
 Source: Barclays Capital



The covered bond investor distribution data (Chart 3) underlines the need to carefully consider any changes to the regulatory regime of liquidity rules given, as stated in paragraph 29 of the Consultation, the need to minimise the negative impact on the financial system and broader economy.

Covered bonds are key in providing many European homeowners access to property financing and is considered by investors to be of supreme credit quality – not least because of the model and its success in several European countries over the past 100 years. The fact that no credit losses have been recorded from covered bonds further underlines the unique strength of the product. The covered bond market is consequently key to banks' stocks of liquid assets and daily liquidity management on a par with government bonds.

We have divided our response to the consultative document into three sections:

In **Section A**, we provide market data and trading statistics accentuating our view that covered bonds held up well in the current crisis in comparison with other assets such as sovereign bonds from the periphery of the euro area as well as securitisation markets and corporate bond markets.

In **Section B**, we argue that covered bonds should be included in the narrow definition of highly liquid assets and provide evidence to support this case based on the fundamental characteristics of covered bonds.

In **Section C**, we would like to comment on the methodology proposed by the Basel Committee, mainly on the Liquidity Coverage Ratio (LCR) and raise several issues that could contribute towards improving liquidity standards for the final version of the proposed liquidity risk framework.

In **Section D**, we would like to comment on the role of covered bonds as a funding instrument and how particular covered bond specific business models would be heavily impacted by an unchanged implementation of the liquidity standards outlined in the Consultation.

Section A – Market Related Issues Regarding Covered Bonds

Covered bonds in general play a vital role in domestic residential mortgage financing. In this respect, we would like to highlight data from the European Mortgage Federation (EMF) on the proportion of outstanding covered bonds to GDP (Table 1) and the share of covered bonds in funding residential loans (Table 2) in order to highlight the relevance and importance of national covered bond markets for their corresponding country of origin. Therefore, any distortion in the domestic covered bond market caused by the rapid adoption of a new set of regulatory limitations influencing the investment behaviour of banks in covered bonds as well as the issuance activity of covered bonds by banks might consequently lead to highly adverse effects on domestic residential mortgage funding. This could impact in the form of higher mortgage yields for retail customers, probably less competition in domestic mortgage markets as well as less choice with regard to the range of mortgage products being offered by banks.

Table 1: Outstanding Covered Bond volume of selected countries to national GDP in %

Source: European Mortgage Federation Hypostat report 2008

Covered Bonds as % of GDP (2008)	
Denmark	156,8%
Sweden	38,5%
Spain	28,8%
Ireland	12,4%
Portugal	9,2%

Table 2: Outstanding mortgage backed Covered Bond volume of selected countries vs. residential mortgage volume

Source: European Mortgage Federation Hypostat report 2008

in €bn	Total residential loans outstanding	Total mortgage backed Covered Bonds	Share of Covered Bond Funding
France	700.8	119.1	17.0%
Spain	674.4	307.5	45.6%
Portugal	105.2	15.3	14.5%
Sweden	199.1	126.4	63.5%

Denmark is probably the most prominent user of covered bonds when it comes to financing residential mortgages. Here, an amount close to 100% of residential mortgages is refinanced via the corresponding domestic covered bonds (Source: Association of Danish Mortgage Banks).

With regard to market depth and market breadth for highly rated non-government bonds, we would like to point to well established bond indices from iBoxx in order to show that the total outstanding amount of AAA and AA rated corporate bonds in contrast to covered bonds is almost insignificant. There is another quite striking difference in these two market segments. While the AAA space for corporate bonds is populated by just one issuer and the lowest rating category (below A, i.e. the BBB segment) is by far the largest in terms of volume, covered bonds offer the opposite picture: 75% of

index volume in the iBoxx € Covered index are rated AAA, the AA rated category is the lowest rating class, just contributing 3% to overall index volume (see Charts 5 and 6).

Chart 5: Absolute market size of iBoxx € Covered Index by Bloomberg Composite Rating

Source: Bloomberg, LBBW

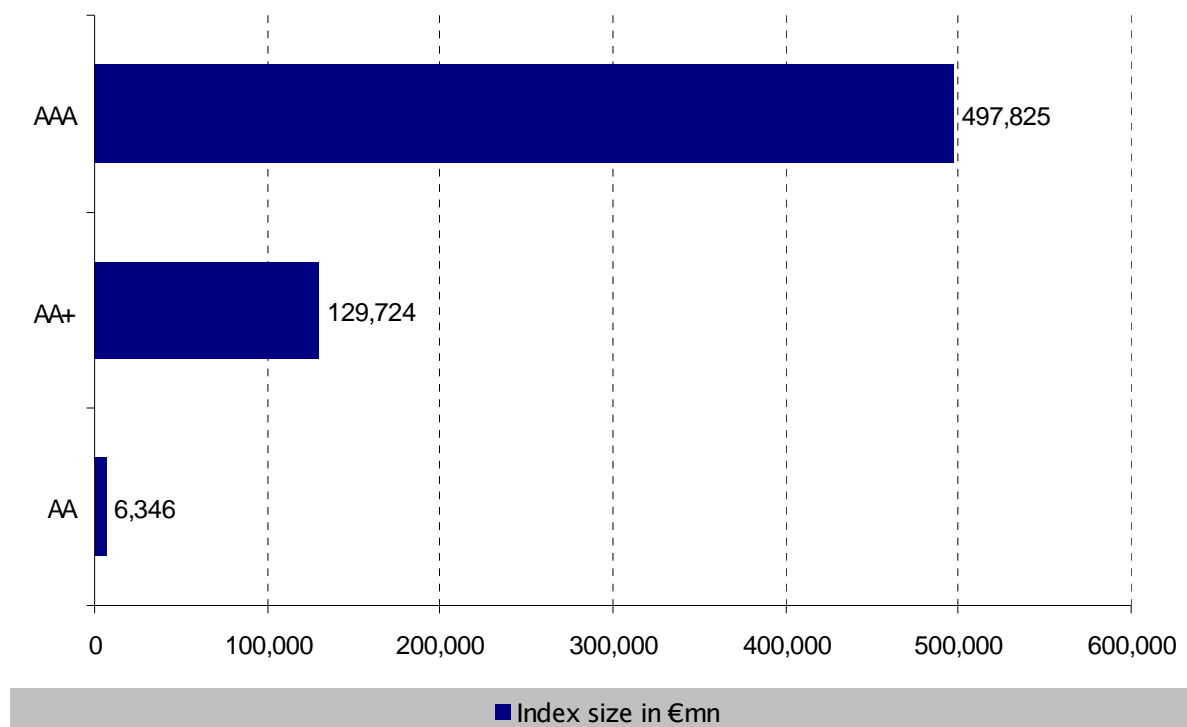


Chart 6: Relative market size of iBoxx € Covered Index by Bloomberg Composite Rating

Source: Bloomberg, LBBW

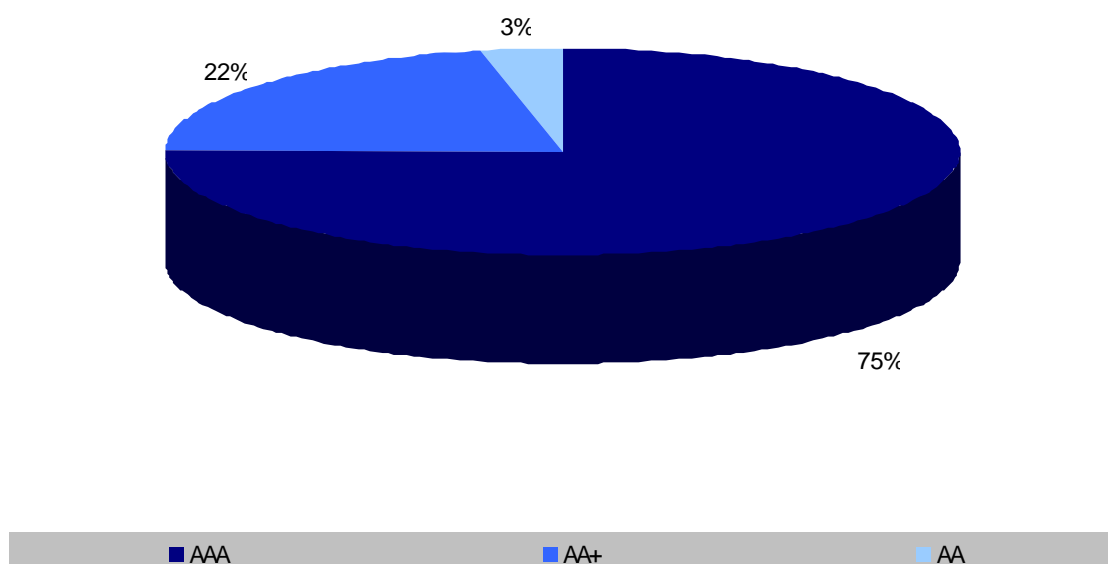


Chart 7: Absolute market size of iBoxx € Non-Financials Index by Bloomberg Composite Rating

Source: Bloomberg, LBBW

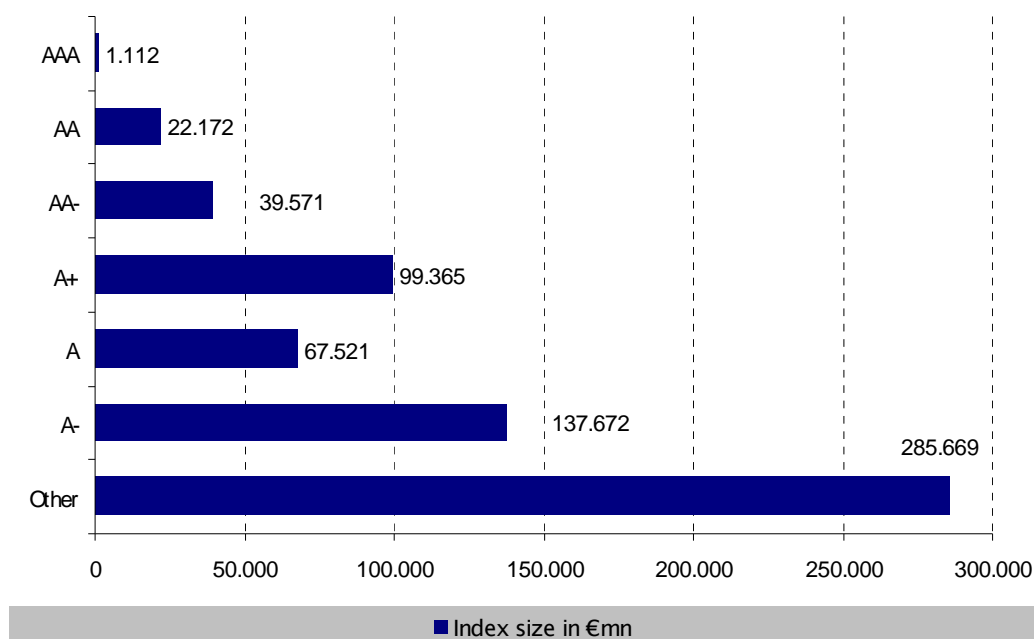
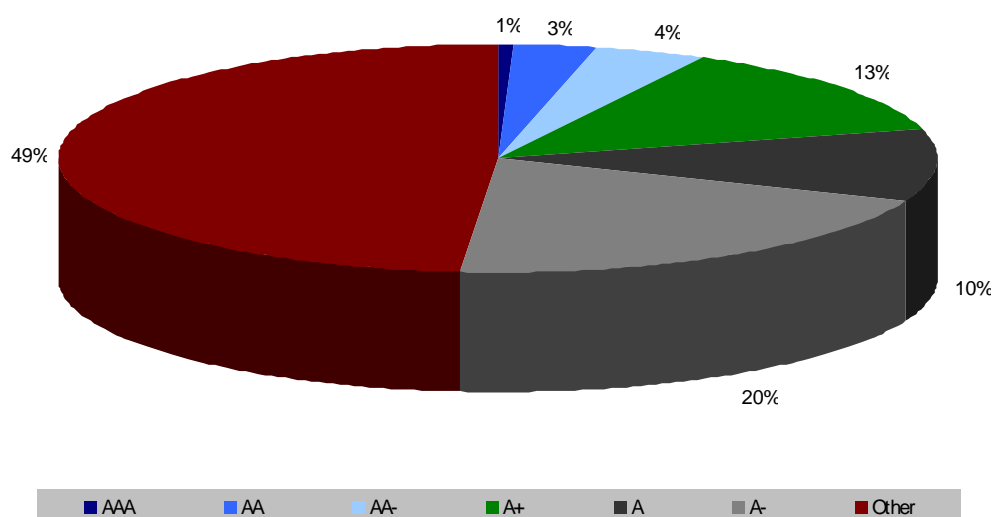


Chart 8: Relative market size of iBoxx € Non-Financials Index by Bloomberg Composite Rating

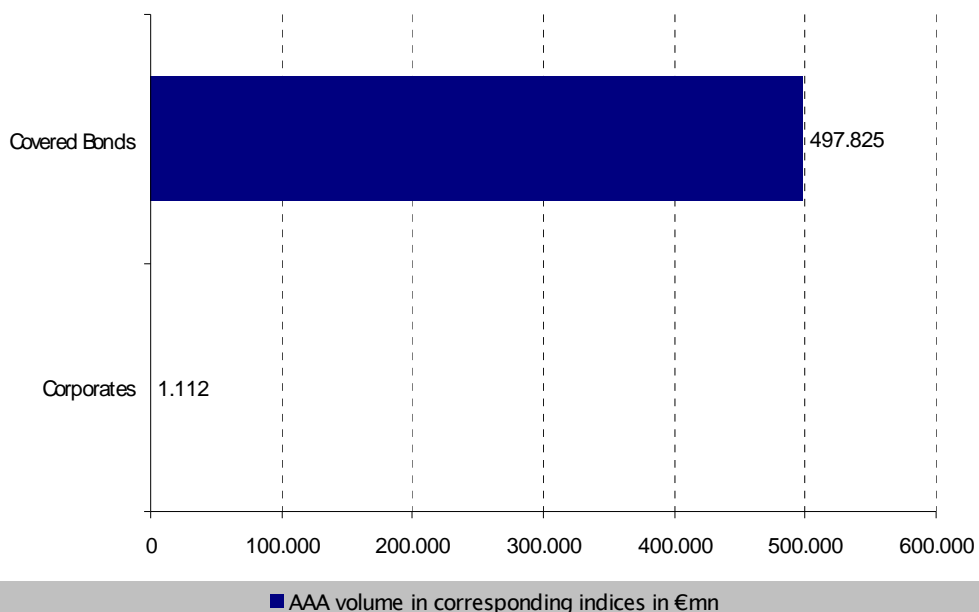
Source: Bloomberg, LBBW



The following chart (Chart 9) underpins our view that covered bonds are absolutely essential in order to create a well diversified portfolio of liquid assets as the corporate universe simply does not offer anywhere near an investment alternative.

Chart 9: Comparison of iBoxx € Covered vs. iBoxx € Non-Financials in the AAA space

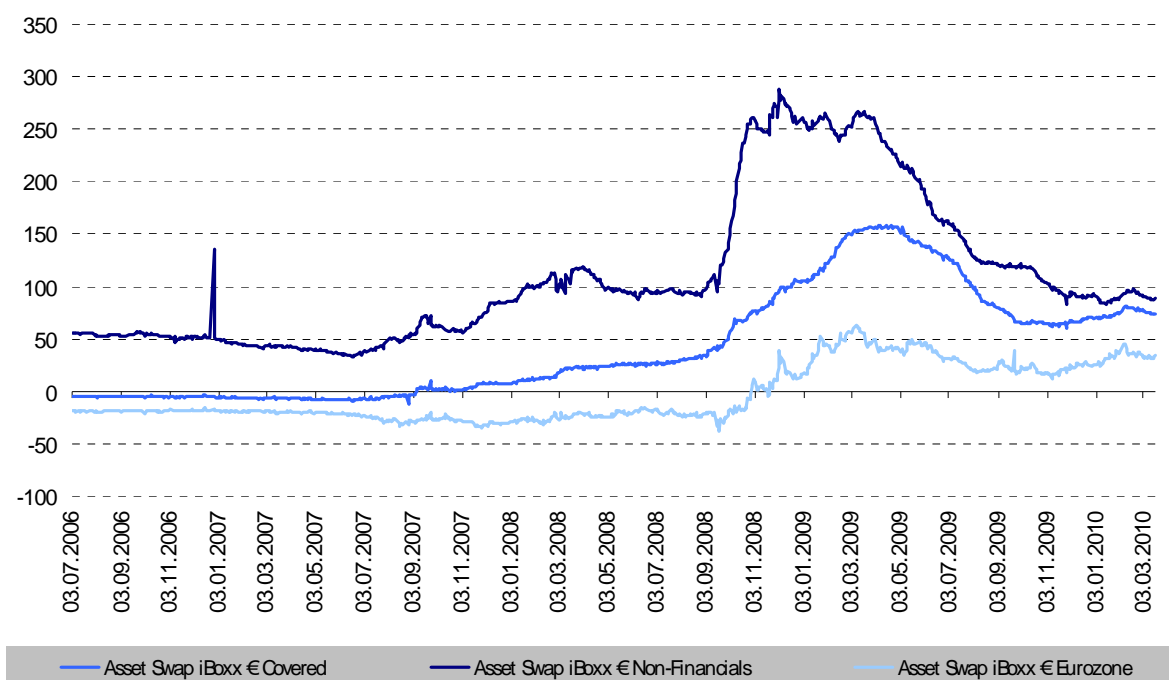
Source: Bloomberg, LBBW



With regard to the low swap spread correlation of covered bonds to risky assets, we do not think that a comparison between covered bonds and for example, structured finance products would provide much insight. However, when looking at the correlation of covered bonds with government bonds, we find that these two assets classes are highly correlated in absolute terms (91% for the period July 2006 to March 2010). The correlation of corporate bonds to government bonds in contrast is significantly lower at around 68%. We believe that the high correlation of covered bonds and government bonds is another expression of the closeness of covered bonds and government bonds in terms of credit quality, for example, as public sector backed covered bonds use sovereign and sub-sovereign debt as underlying assets.

Chart 10: Asset Swap Spread of iBoxx indices in basis points

Source: Bloomberg, LBBW



Section B – Covered Bonds – A Highly Liquid Asset Class

▪ Equal treatment of Corporate Bonds vs. Covered Bonds

The nature of covered bonds as secured bank debt is a more homogenous one than the one for corporate bonds. **One fundamental argument is the existence of special laws and a great extent of standardisation.** As a major difference, covered bonds offer a dual recourse to the issuing bank as well as to a well defined pool of high quality assets. Covered bonds are a product regulated by law and subject to specific supervision. Consequently, there are provisions such as UCITS 22(4), CRD article 68, which aim at a preferential supervisory treatment of covered bonds. The UCITS 22(4) Directive, for example, justifies larger exposures on behalf of institutional investors to covered bonds, which we interpret as a sign of confidence in the credit quality of covered bonds fulfilling the stipulations of the Directive. When looking at the definition of covered bonds given in footnote 11 of the consultative document in comparison to UCITS 22(4), we struggle to find any difference. Furthermore, the CRD allows for a reduced risk weighting of 10% in the standard Basel risk approach for any banks investing in covered bonds. The current Basel II framework in general does not recognise covered bonds as special instrument, but the CRD as an EU Directive has put a significant effort into defining and specifying covered bonds which in turn qualify certain covered bonds to receive a preferential treatment with regard to applying bank's capital to its inherent risks.

The difference in terms of market volumes between highly rated corporate bonds and covered bonds has already been outlined in Section A. Due to the favourable regulatory environment over past decades for covered bonds, **this asset class has developed a deep and loyal customer base.** Furthermore, covered bonds are not only issued in benchmark format, but also in the format of traditional bearer bonds and registered covered bonds, thereby attracting a broad and well diversified investor base. In turn, such a favourable investor landscape creates stable funding opportunities as shown by the example of the Bundesbank figures and also of highly liquid markets. This is not necessarily the case for corporate bonds as registered corporate bonds instead of bearer bonds have an insignificant market share. Taking into account especially the segment of registered covered bonds, the asset class of covered bonds as a whole offers the opportunity for banks to issue on average longer maturities than in the senior bank debt market. Accordingly, covered bonds offer the opportunity for rate investors to actively position themselves on the yield curve. In other terms: not commenting on the debate as to whether covered bonds are a rates or a credit product, which is also debatable for certain government bonds also under the step 1 definition of the Basel II standard risk approach, flows and therefore increased tradability in the covered bond markets are created by the fact **that in addition to buy-and-hold investors, trading accounts are also active here, following certain rates strategies. However, in no way will the stability of a funding strategy based on covered bonds be affected, also bearing in mind that the covered bond product does not typically allow acceleration clauses.**

When it comes to **recovery rates for covered bonds**, there is an astonishing lack of data. As there have been no defaults in covered bonds as far as the ECBC is aware of (which translates into: not a single covered bond has ever been accelerated according to its programme), despite the default of several covered bond issuers, we can only make qualified guesses about the potential recovery rate for these instruments. While we tend to observe a recovery rate of between 20% and 30% for senior bank debt (e.g. Lehman or Icelandic banks), the recovery should be by far better for covered bonds. Without going into too much detail, we would like to refer to the covered bond rating methodology

from Fitch, which is partly based on recovery assumptions for the cover pool. Looking at the bonds which have a Fitch covered bond rating, as of March 2010, in all cases were stressed recoveries from the cover pool have been modelled, the covered bonds are in the highest recovery rating ("Outstanding"), which translates into a recovery assumption between 91% and 100% for the covered bonds concerned. Therefore, **the credit risk in covered bonds is limited** when applying this fundamental ratio and in turn, any market disruption in a particular covered bond should be short lived. Furthermore, the argument of significantly higher recovery rates clearly distinguishes covered from corporate bonds and emphasizes their secure nature.

Table 3: Recovery Ratings from Fitch, being applied to also covered bonds within the methodology of Fitch

Source: Fitch

Maximum Notching above Covered Bond's PD Rating			
Recovery prospects	Recovery range (%)	Investment grade	Non-investment grade
Outstanding	91-100	+2	+3
Superior	71-90	+1	+2
Good	51-70	+1	+1
Average	31-50	-	-
Below average	11-30	-1	-1
Poor	0-10	-1/-2	-2/-3

Source: Fitch

Looking at the criteria, the so called *Fundamental Characteristics* set out by the consultative document in section 29, we created the following table using the input from the Basel Committee and applied these criteria to the covered bond market. We do not want to argue against the inclusion of well rated corporate bonds in the liquidity framework. We just want to stress that the ECBC is not the body to have a deeper and sufficiently profound knowledge of corporate bonds and how to evaluate them in the context of the criteria laid out.

Table 4: Fundamental Characteristics of section 29 consultative documents applied to the Covered Bond Market

Source: Basel Committee, ECBC

Criterion	Applies to Covered Bonds
1) Low credit and market risk	
High credit standing of the issuer	Yes, given for the issue itself
Low degree of subordination	Yes, preferential claim on cover pool assets plus dual recourse
Low duration, low volatility, low inflation risk, convertible currency	Yes, in line and partly better than government bonds from Eurozone periphery
2) Ease and certainty of valuation	
Liquid asset pricing formula	Yes, majority is fixed or floating bonds, no model assumptions needed to price plain vanilla Covered Bonds
Exotic product	No, track record since late 18th century
3) Low correlation with risky asset	
Wrong-way risk	No, as insolvency remoteness and special law ensure credit quality of cover pool. In contrast, correlation of 91% with government bonds
4) Listed on exchange market	Yes, although the majority of trading turnover does not necessarily take place there
5) Active and sizable market	
Outright sale and repo	Yes, see appendix for overview of repo market
Market breadth and market depth	Yes, is given, simply looking at involvement of Central Banks as market participants
6) Committed Market Makers	Yes, although Market Making is not enforceable
7) Low market concentration	Yes, given due to investor space ranging from large accounts to small asset managers, see e.g. granularity of order books
8) Flight to quality	Yes, firstly see high correlation with government bonds.

▪ **Underlying assets backing public sector backed covered bonds**

Looking for example at public sector backed covered bonds like the Öffentlicher Pfandbrief from Germany or the Lettre de Gage publique out of Luxembourg, these bonds are mainly backed by assets, which largely include the set of assets outlined in the narrow definition of liquidity (see page 9, bullet point 34). Therefore, applying a look-through principle to these type of bonds, they are nothing other than a pool of eligible assets according to the narrow liquidity definition, ring-fenced and insolvency remote due to the existence of a special covered bond law, just being bought, managed and issued by a bank. In the case of Germany, we note an outstanding market volume of €486 bn Öffentliche Pfandbriefe as of yearend 2009 according to Bundesbank data.

▪ **Unlimited inclusion of 0% risk weighted government bonds**

The consultative documents is considering 0% risk weighted government bonds or bonds carrying any kind of public guarantee, which leads to a 0% risk weighting, as highly liquid assets, as long as they fulfil the Fundamental Characteristics in section 29 (see Table 4 above). As we are not aware of any obligation within the consultative documents asking explicitly for portfolio diversification, a

highly liquid portfolio of assets might be assembled by any bank without contradicting the new liquidity measures by simply buying government bonds out of just one country. Besides the concentration risk issue, which we do not want to follow here, we would like to point out the dangers of sudden market distortions which can also occur in government bond trading, having easily been observable during the course of the first quarter 2010. As the fundamental characteristics may no longer apply due to sudden changes, a portfolio of formerly 100% highly liquid assets might lose this status overnight. As a consequence, the bank would have to be considered illiquid.

- **More reliance on central banks when defining liquid assets** as these institutions invest in covered bonds (see e.g. simply the ECB's €60bn Covered Bond buying programme) for a number of reasons. Central banks also have to assess the liquidity of various assets almost on a daily basis when looking at the catalogue of their repo eligible assets. In addition, a good portion of central banks are also active and involved in the area of supervising business banks, which gives them some kind of information advantage when having to assess the credit quality of bonds (including covered bonds) issued by banks. It might therefore be an option worth being considered to base the system and the measurement of highly liquid assets more towards the judgement of the central banks and their haircuts on certain assets within their repo transactions. It might be an option to follow more closely central bank's repo haircut policy on covered bonds when it comes to applying haircuts in the context of liquidity purposes. As central bank eligibility of covered bonds is also one major argument in our Section B for an amendment of the LCR and the NSFR, a close link of central bank eligibility and recognition as liquid assets would create automatically a symmetric system: If an assets loses its central bank eligibility (which translates into a 100% haircut), any multiple of it within the liquidity standards would also translate into a complete non-recognition as liquid assets. This trigger would even work independently from ratings or market spreads.

- **Using market data for assessing bond liquidity**

In our view, there is a fundamental conceptual problem when trying to assess the liquidity of any kind of bond by its bid/ask spread. As the majority of bonds especially in the credit universe are still traded by so-called phone trading and not on electronic platforms, it is by no means a trivial task to determine the pricing source on which to base the assessment of bid/ask spreads. It is common business practice to quote different prices for bonds to different customers at the very same point of time. Therefore, the fair and objective observability of executable bond prices is questionable per se. In other words: it will almost be impossible to capture consistent and coherent bond prices for a market driven approach to determine the liquidity of a bond (i.e. the tradability of that particular bond) without a clear guidance of which pricing source to use. We support the Basel Committee in its approach to use market data in general but we must emphasize the complexity of putting in place a regulatory guideline of 50 basis points into daily business for banks.

- **Relevant market**

Looking at bullet point no. 37, page 10, we have not been able to accurately assess whether this set of rules shall apply to a single bond (i.e. each individual bond has to fulfil footnote no. 11 plus the rating criteria plus bid/ask yield spread plus the proven track record) or to a whole segment of the covered bond market. While on the one hand, it surely makes sense to base the assessment on the issuer level, the current way bullet point no. 37 is written could be interpreted in a misleading way that e.g. one issuer in a particular country (e.g. Germany) having had a bid/ask spread above 50 bp in the past for a couple of days might spoil the whole market for Pfandbriefe. As many countries

have supported banks in Europe, thereby also supporting covered bond issuing institutions, a reference from one issuer to the national market as a whole would more or less lead to the exclusion of covered bonds as highly liquid asset as there are cases of troubled issuers in almost all relevant markets.

- Negative interest margin on liquid assets puts downward pressure on capitalisation. One aspect of liquidity is hardly addressed in the consultative document, which is the topic of decreased profitability of banks due to increased and tightened liquidity requirements. We believe it is a fair and realistic assumption that banks refinance themselves at levels significantly above government bonds with a 0% risk weighting according to the Basel standardised risk approach. The market environment regarding current spreads from Southern European government bonds is considered only to be temporarily by the ECBC. Therefore, by requesting banks to hold on average more government bonds in the future to the disadvantage of covered bonds compared to the current situation, this requirement would create further pressure on the overall profitability of banks as the negative interest margin on the portfolio of highly liquid assets gets larger. Without being able to assess the actual extent of this effect, all other things being equal, puts downward pressure on banks capitalisation, possibly creating further pressure on the market access of various funding sources. Depending on the extent of this effect, it might even on balance add more to the financial instability of the banking sector instead of decreasing it.

Section C – Technical Issues

▪ Hair cut

We believe that the proposed haircuts of 20% or 40% respectively are very restrictive, as covered bonds are in general repo-eligible with central banks and private sector banks at a considerably lower haircut. Also, the previous argument that the maturity of the underlying assets is not taken into accounts is also detrimental to daily repo business with either central banks or private sector banks. The present proposal means that covered bonds irrespective of their maturity will by definition be trading at a haircut of at least 20% in the repo market in order not to put a strain on liquidity providers' own liquidity. In practice, this will be detrimental to money markets – especially in countries where the covered bond market by far exceeds the government bond market in size. This is the case for instance in Denmark.

Furthermore, we are aware of certain problems involved when trying to define highly liquid assets on a global scale as the Basel Committee is currently undertaking. We welcome these efforts and support them in order to achieve a more liquid and stable banking system. However, we wonder whether the process of defining and actually recognising certain assets as being highly liquid should be exclusively up to the Basel Committee as a regulatory body with representatives from all major banking systems worldwide or whether the new framework for liquidity standards should possibly also include the option to have national banking supervisors allowing banks on a national level for the inclusion of assets, which are not or not fully recognised under the current proposal. Having said that, we would like to raise the point that the national banking supervisors surely have a vast expertise in their home markets and the corresponding liquidity in these markets. We therefore are of the opinion that an inclusion of well specified assets upon the approval of the national banking supervisor should be taken into account within the Basel framework for liquidity.

In addition to the proposal of a closer link between central bank eligibility and recognition within liquidity standards, **we would like to raise the point of maturities of underlying assets.** Within the consultative document, a haircut on highly liquid assets of 20% or 40% would be applied to all covered bonds irrespective of the remaining maturity of the bonds in consideration. We believe that this approach is too static and too simplistic, because of potentially huge differences in pricing volatility with regard to the maturity of the various bonds in consideration. Also by referring to central banks' repo policy, it is evident that the haircuts on shorter maturities are lower than on longer term maturities.

Given the proposed haircuts and the proximity in trading levels between covered bonds and government bonds, it is almost impossible to see covered bonds being used meaningfully for the purposes of the LCR on economic grounds. Additionally the increased capital charges over government securities (typically 5-10%) under AIRB, will further ensure it is not economical for banks to hold sizeable quantities of this product in spite of its excellent track record, better ratings stability and default history than government securities. Giving banks more incentive to hold a meaningful amount of the product under the LCR would also somewhat mitigate the effects of the "race" for long term investors/deposits caused by the NSFR by creating a healthy end investor demand for safe longer duration liabilities.

▪ **Self retained bonds**

Under the current proposals of the consultative document, credit institutions would be penalised for holding their own covered bonds. Covered bonds have proven to be a liquid instrument throughout the crisis. It needs to be stressed that issuers quite frequently acquire own covered bonds in the market as part of their ALM management and thus improve the overall liquidity in their bonds, attracting more investors, etc. This type of market making by the issuer itself is not typically observed with either issuers of corporate bonds, or government bonds.

In some countries, for example Denmark, mortgage banks carry on business as securities dealers, buying own covered bonds in the secondary market. Their portfolios of own covered bonds are thus essential to their ability to quote prices to investors – and ultimately to borrowers in connection with the disbursement and prepayment of mortgage loans – and to secure the necessary liquidity in connection with lending transactions.

Furthermore, the fact that banks may under no circumstances under the current proposals of the consultative document include own covered bonds when determining their stocks of liquid assets creates other structural problems – we would like to refer to Section D of this Position Paper for further discussion on the question of specialised banks:

- This may not create a level playing field depending on an issuer's affiliation to a group – not least if the group includes several covered bond issuers, and the group may therefore obtain liquidity by an intercompany "exchange" of bonds.
- In markets characterised by few issuers, but deep secondary market liquidity, obtaining liquidity will be a considerable challenge to these issuers.

▪ **Inconsistencies in LCR and NSFR**

In our view, the way covered bonds are represented in the definition of the LCR and the NSFR is inconsistent and inappropriate. When it comes to the LCR, we note that covered bond funding would not qualify for the exceptions made in the calculation for the "secured funding run-off". First, this is against empirical evidence. Even at the height of the recent financial market crisis, in Q4 08 and Q1 09, there was ongoing issuance activity in particular through privately placed covered bonds, whilst other unsecured funding sources dried up. Second, we would regard it as inconsistent to assume that refinancing via covered bonds would be impossible, whilst at the same time covered bonds qualify for the "stock of high quality liquid assets", which actually implies that there is a bid for covered bonds even in times of stress.

When it comes to the NSFR, we note that covered bonds with a term to maturity of less than one year would not fall under the definition of "available stable funding sources". At the same time, when it comes to the definition of "required stable funding uses", under certain circumstances, covered bonds qualify for an RSF (Required Stable Funding) factor of 20%, which implies that covered bond holdings could be monetised. Thus, again, as within the definition of the LCR, disregarding completely the ability of banks to refinance via covered bonds is not only in contrast to empirical evidence but also inconsistent with the assumption that covered bonds could be sold in the secondary market.

▪ **Rating triggers**

The consultative document is considering corporate as well as covered bonds under a broad definition of liquidity as highly liquid assets as long as certain specified criteria are met. One of them is the rating trigger of AA and A- respectively. We would welcome some more explanation as to why the rating level of AA in particular was chosen. When looking at the criteria for government bonds laid out in Section 34, there is no direct rating trigger. Instead, a reference to all government entities with a 0% risk weight under the Basel II standard approach is given – which translates into a rating trigger of AA- as far as we are aware of. So it would be more consistent in our view to have a common rating trigger of AA- (implicitly by 0% risk weight or explicitly) instead of applying different rating levels to different asset classes.

▪ **Creating instability by introducing jump levels**

We are concerned by the clearly specified triggers within the proposed Basel framework on liquidity such as the limit of 50 basis point bid/ask spread for corporate or covered bonds. We strongly argue against this kind of banking supervision by strict market measurement as we have learnt from the current crisis that such a trigger creates and inflicts instability on the banking sector. Looking at the example of recognising highly liquid assets by their bid/offer spread, two problems immediately arise:

There will be reaction such as a fire sale on behalf of those banks owning assets within the definition of being “highly liquid”, when a widening of the bid/ask spreads is to be observed, which is still below the barrier of 50 bp but getting closer to it. In order to avoid the loss of recognition as liquid assets, it is a fair assumption based on the observation of banking behaviour in the past that these assets will be sold BEFORE reaching the trigger level – causing drops in prices, driving bid/ask spreads higher and basically creating a self-fulfilling prophecy. We would consider any kind of approach to define liquid assets as inappropriate where it is based on strict rules in combination with the belief that this set of rules is so well defined that any kind of trade activity of this asset, even in times of stress, does not change the underlying trading pattern of e.g. bid/ask spreads.

In our view, the same argument of inherent instability due to strictly defined trigger levels also applies to the limitation of 1-year maturities within the NSFR methodology.

▪ **Conditions for Liquidity Buffer Holdings**

Regarding the application of the new rules, the respective proposal only refers to the reporting and calculation of the suggested metrics as well as the scope of its application. It is not mentioned, under which conditions banks would eventually be able to make use of liquidity buffer investments. Not allowing banks to sell liquidity buffer investments under certain circumstances is inconsistent with the whole idea of maintaining a liquidity buffer, as this means that:

- a) the respective investments are basically not available for sale and thus inherently illiquid; and
- b) banks are forced to maintain additional liquidity holdings on top of their liquidity buffer investments in order to be able to factually raise liquidity when they are under stress.

In order to allow banks to smoothen liquidity squeezes with their liquidity buffer holdings, it should be considered to introduce clear and easily applicable rules under which the respective securities could be used, in case an institution and/or a whole market segment needs to counter stressful liquidity conditions.

Section D – Covered Bonds as a Funding Instrument

▪ **Non-recognition of securities below 1 year in the Net Stable Funding ratio**

Banks may pursue a matched funding strategy in respect of their lending funded by their covered bond issuance. The strategy implies that payments of interest on and redemptions of issued bonds fully match payments of interest and principal on the underlying loans. These credit institutions have thus by definition eliminated all market risk – including liquidity risk – leaving only credit risk. According to the matched funding strategy, the final terms of a loan on disbursement or the price of prepayment is fixed based on the current price of the underlying bonds. Credit institutions therefore have to make tap issues and cancellations on a daily basis and participate actively in the secondary market with their own bonds.

If a credit institution pursues a matched funding strategy in respect of its lending, which means that the terms governing the payment of interest and principal on a loan will be adjusted to match changes in the credit institution's funding terms, the credit institution in principle incurs no liquidity risk, as it can survive refinancing this lending even in stressful periods.

One example is Danish mortgage banks' funding of adjustable-rate mortgages. During the recent financial crisis, Danish mortgage banks have been able to continuously refinance mortgage loans funded by short-term bonds – in 2009 amounting to roughly DKK 500bn (about EUR 65bn) – by issuing new covered bonds sold at auctions in the bond market. Therefore, the non-recognition of covered bonds with a maturity of one year within the framework of the calculation of the net stable funding base of a bank does not adequately reflect underlying economic realities of the Danish covered bond market and (besides putting severe stress on a business model, which has proved to be solid in times of severe stress) would leave Danish mortgage clients with less choice and probably higher costs to finance their homes.

▪ **Universal bank principle vs. special bank principle**

The type of bank which the Basel Committee seems to have in mind when proposing the new liquidity standards obviously is a universal bank. While this is of course the most natural point to start from, we would like to emphasize the fact that in a lot of European countries, covered bonds must be issued by special banks due to the special bank principle laid out in the corresponding national covered bond legislation. Therefore, these banks are heavily reliant on covered bonds as a funding tool, not being able to tap, for example, the deposit market due to legal restrictions. While we acknowledge that specialised issuers of covered bonds will per se not be able to achieve a well diversified funding structure due to existing legal limitations, this might be mitigated by the fact some special banks are subsidiaries within a banking group. Therefore, the relevant funding mix to consider should be on the group level, not on the level of each bank within a banking group. In our view, the consultative document is not overly precise on this point, whether to apply the liquidity standards to a consolidated banking group or to each member of the group which leads to a need for further specification here.

However, there are still a significant number of specialised banks (despite being possibly licensed as a universal bank) or even banking groups, which voluntarily have chosen to restrict themselves to certain businesses which in turn results in a very frequent use of covered bonds as the major source of refinancing. Examples can be found in France (e.g. Dexia), Luxembourg, Spain (e.g. Banco Credit

Local) or Germany (e.g. Münchener Hypothekenbank). The application of a narrow definition of liquid assets would introduce a severe distortion into the covered bond market, that would as a consequence bring into question the sustainability of the business model of banks concerned. The natural reaction of such credit institutions would be to seek new sources of funding (if legally possible according to legal boundaries within a covered bond legislation) and turn, for example, to the deposit market. This new and definitely aggressive market entrance would then seek to replace a decent portion of their previous covered bond funding by deposits, which would in turn erode the funding channels for traditional large deposit taking institutions, which is again not helpful in our view when the main goal is to create a more stable banking system. Moreover, any new (retail) deposits would also be structurally subordinated to the outstanding covered bonds of those issuers.