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EMF POSITION PAPER

Basel Committee on Banking Supervision Consultations on Strengthening the Resilience of the Banking Sector and an International Framework for Liquidity Risk Measurement, Standards and Monitoring

Founded in 1967, the European Mortgage Federation represents the interests of mortgage lenders at EU level on both the retail and lending side. It groups national associations and individual lenders from amongst the EU 27 and the Accession Countries. Together, its members grant approximately 80% of mortgage loans in Europe. The volume of mortgage loans exceeded €6.1 trillion at the end of 2008. The Federation is the key-talking partner of the European Commission, the European Parliament, the Committee of European Banking Supervisors, the European Central Bank and the Basel Committee on all questions relating to the mortgage industry.

1. Executive Summary

The European Mortgage Federation and its members are very pleased to be able to provide a response to the Basel Committee consultations on 'Strengthening the resilience of the banking sector' and an 'International framework for liquidity risk measurement, standards and monitoring'.

The EMF supports the efforts of the Basel Committee to improve the resilience of the global financial system; and to ensure a level playing field by promoting a global reform agenda on financial regulation. The proposals contained in both documents are of major significance to our industry.

Some in particular, have deep implications for the mortgage lending industry. In most cases the measures, though sound in principle, run foul in their application to certain banking business models prevalent in Europe. This is of very serious concern to the industry as some of the proposals have the potential to either eradicate certain financial institutions, or severely constrain their operations. This is all the more worrying, considering the critical role mortgage credit is to play in the relaunching of economic activity, post-crisis.

Therefore, the contents of the present position are focused on two key areas of major concern to members of the EMF: Liquidity standards and leverage ratio. On the section on liquidity standards, we would also like to express our full support to the response prepared by the European Covered Bond Council for the Basel Committee.

- **Liquidity Standards**

The introduction of two liquidity metrics to manage liquidity risk is welcomed. Our comments are limited to the inclusion of certain assets in the ratios and their treatment. These concern covered bonds more specifically where the Liquidity Coverage Ratio and the Net Stable Funding Ratio have the potential to harm existing business models.

The recommendations in this section are as follows:

- Eligibility of covered bonds as high quality liquid assets for the LCR buffer;
- The removal of the restriction whereby **covered bonds** cannot make up more than 50% of the buffer in the LCR;
- Preferential treatment of covered bonds as compared to corporate bonds is called for;
- Removal of the ineligibility of own-issued covered bonds in the calculation of highly liquid assets and required stable funding. Under the required stable funding calculation, own-issued covered bonds should be counted like all similar covered bonds;
- Implementation of the same haircuts as those used by the ECB and other central banks;
- The removal of further conditionality placed on covered bonds relating to bid-ask yield spread and historic price declines;
- The exclusion of AAA to AA rated covered bonds from any funding coverage requirement. A-rated covered bonds should be subject to a lower coverage requirement than the currently proposed 50%;
- For the required coverage calculation in the NSFR, we recommend the inclusion of all retail loans in the 85% bucket, rather than the 100% bucket, as recognition of the partial cash flow features of these assets; and
- Proposal for an amendment to the NSFR definition to assign an availability factor of 100% to covered bonds irrespective of the remaining term to maturity, subject to certain criteria being met (i.e evidence of a match funding model, or appropriate legislation minimizing liquidity risk).

- **Leverage Ratio**

The leverage ratio is regarded as a blunt tool which runs counter to the risk-based framework ushered in by the Basel II framework. It discriminates to a damaging degree, against low-risk, high-volume businesses like mortgage lending.

Highly liquid assets as recognized under the liquidity buffer should be excluded from the total exposure figure. A failure to exclude such assets from the exposure figure would reduce the propensity of banks to hold covered bonds in their liquidity buffer at all, striking at a very important source of mortgage funding in Europe.

The EMF strongly recommends that if a leverage ratio is nevertheless deemed necessary in the present package of reforms, it should be included under Pillar II where it might add value without threatening to destabilize whole swathes of the European mortgage lending sector.

2. Liquidity Standards

The EMF considers the introduction of regulatory standards on liquidity risk as an apt response to the problems thrown up by the financial crisis. A Liquidity Coverage Ratio (LCR) covering liquidity needs over a 30-day stress scenario, and a Net Stable Funding Ratio (NSFR) promoting more stable sources of funding over a one-year outlook, appear to be appropriate monitoring tools, and should help prevent problems arising from liquidity management.

Mandatory liquidity buffers will however come at a cost to credit institutions, the investor community, and to society more broadly. This is compounded by the fact that most economies are struggling to come out of recession and achieve a sustainable growth path.

Our comments are therefore aimed toward preserving the viability and efficiency of the proposed liquidity buffers, while minimising the adverse impacts on financial markets, and mortgage lending in particular.

It is understood that the objective of the rules is to prevent the need for public sector intervention like on a scale seen during the crisis. Nevertheless, this should not mean that the role of central banks in providing liquidity under certain circumstances should be fully excluded. Such an assumption is misguided as the past crisis has shown effective liquidity facilities provided by central banks. This assumption also leads to a much narrower list of eligible highly liquid assets which in turn can result in severe market distortions. This will be discussed further down.

Another general concern is the potential for these measures to limit the maturity transformation role of banks. Aligning the needs of borrowers to obtain credit over the long-term, and investors to lend short, is a key function fulfilled by banks. The liquidity rules under the current calibration would seriously constrain maturity transformation by banks, and more worryingly would probably see it migrate outside to the unregulated sector.

2.1 The systemic implications of the LCR and NSFR proposals

The narrow definition of the buffer will increase concentration in eligible assets which in turn would create massive distortions in the market. With banks being forced to hold mostly cash and government bonds under the LCR, there would be large upward price pressure on government debt and a corresponding decline in yields. This would be in addition to the change in returns experienced by requiring banks to hold more government bonds to the detriment of other asset types, like Covered Bonds. Lower profitability by banks would have a direct impact on the cost and availability of credit to the economy. Another unintended consequence of too costly liquidity requirements would be to push banks into higher risk business to compensate for holding low margin, or unprofitable assets. This would result in a weakening of the capital position of banks which clearly is not the intention of the proposed rules.

Similarly, a reduced market for covered bonds and bank securities would increase the overall cost of issuance for banks looking to raise funding. In summary, we would expect increased costs and

reduced funding possibilities for banks, both of which would negatively impact the cost of credit to borrowers.

Ironically, a too narrow definition of the LCR buffer would not only cause a flight to a very limited set of asset classes, but this would lead to overall illiquidity as holders would be reluctant to sell or trade in these assets once obtained. In some markets (Denmark is one example), government bonds only account for a small portion of overall bond issuance. A related issue is that, in the event of a systemic crisis, all banks would at the same time be looking to dispose of the same type of assets. This would drive down prices, exacerbating the crisis.

To avoid these problems, we recommend a broader definition of highly liquid assets, one which includes Covered Bonds subject to realistic eligibility criteria, and bank bonds. Covered Bonds will be discussed at length below; bank bonds are an important source of liquidity and their complete exclusion is not justified.

Firstly, the EMF strongly urges the recognition of covered bonds as high quality liquid assets under the new liquidity standards.

We also recommend the removal of the restriction whereby corporate and covered bonds should not make up more than 50% of the buffer. The restriction would otherwise reduce profitability and funding possibilities for banks, both of which would negatively impact on the cost of credit to borrowers.

2.2 Different Banking Business Models

The EMF furthermore considers that the current proposal does not sufficiently take account of the different business models prevalent in the European banking sector. In 2008, covered bonds accounted for over 1/5 (21.6%) of mortgage funding in Europe, only five years earlier this figure was at just 6%. This is clearly a growth area for mortgage funding; in some markets in the EU, covered bonds are the largest source of funding. It is obvious that neither the LRC nor the NSFR take account of the specificities of this model. The following section examines how some of the proposed liquidity metrics would have a disproportionate effect on mortgage lenders, and especially those relying on a covered bond funding model. We would go further in saying that different business models have different liquidity risk profiles which are not duly considered in the two metrics.

If unaddressed, these measures taken together would have a major impact on the real economy, causing some banks to change their entire business models, and driving others out of business. The housing market would as a consequence see reduced supplies of credit, and higher mortgage rates for consumers.

2.3 Covered Bonds

Covered bonds, which are issued by credit institutions, are particularly secure instruments; they are characterised by bondholders' preferential claims on a segregated cover pool of high quality assets in case of the issuer's default. The assets funded via the covered bond, are legally segregated from the remaining bank assets on the balance sheet, they keep their own identity and survival capacity. This endows covered bonds with bankruptcy remoteness, a key differentiating feature from other asset classes. They are also subject to specific legislation and permanent monitoring.

Covered bonds play a vital role in European residential mortgage financing. At 2,4 trillion Euros in outstanding covered bonds in 2008, and with covered bond legislation in 23 EU Member States, there is no doubt as to the size and depth of this market. Beyond the EU, there is also strong evidence of a sustainable international investor base, an extremely healthy secondary market & viable trading platforms.

The consultation document lists a number of fundamental and market-related characteristics which all highly liquid assets should comply with. Covered bonds meet every one of the listed characteristics ranging from low credit and market risk to 'flight to quality features'.

- **Equal treatment of covered bonds and corporate bonds is inconsistent and unjustified**

Given the above mentioned special features of covered bonds, recently evidenced in the European Central Bank's purchase programme post-crisis, we request that the treatment of covered bonds follow the same principles as for government debt. This is widely recognized under current EU legislation. Under Article 52 (4) former 22 (4) of the UCITS Directive, the greater credit quality of covered bonds is recognized, bringing them closer in line with sovereign debt than with corporate bonds as suggested here. UCITS 52 (4) former 22(4) justified larger exposures to a single issuer of covered bonds, the Capital Requirement Directive, in turn, allows for a reduced risk weighting of 10%. And in the most recent revision of the Capital Requirements Directive (Article 113, 2009/111/CE), covered bonds are given the same treatment as government bonds, resulting in an exemption for both asset classes from the large exposure regime for credit institutions. Given the wide recognition of covered bonds' quality at the EU level, it is surprising to find that covered bonds have been classified into the same category as corporate bonds and subjected to the same haircuts. Credit quality ratings of both instruments show significant differences. Ranking covered bonds and ordinary corporate bonds as equivalent in the liquidity metrics will impair the covered bonds market, as covered bonds' relative advantages would go unrecognized. The impact on the investor base should not be underestimated as credit institutions make up a large part of it. An impaired covered bond market in turn, will make covered bonds less attractive to all investors.

- **Covered bond haircuts**

In this light, the suggested haircuts of 20% and 40% appear unduly conservative. More importantly, they do not reflect the reality of the market place where central banks have set much lower haircuts.

It would make more sense if actual central bank conditions were reflected in the haircuts within the LCR. These are currently between 1% and 9% depending on maturity. We urge the Basel Committee to reassess the size of haircuts to reflect the actual credit quality of the bond issuer and the bond's time to maturity, as done currently by central banks in their repo transactions.

Haircuts arbitrarily set at 20% and 40% are doubly unfair, since as we know they are repo-eligible at a considerably lower haircut in all jurisdictions. But the present proposal would mean that covered bonds will by default be trading at a minimum of 20% in the repo market as liquidity providers themselves need to comply with the liquidity requirements.

The key problem, ultimately, arises from the fact that the proposal attempts to define highly liquid assets across jurisdictions and markets where different market conditions might prevail. For this reason, and others cited above it is more advisable to implement the same haircuts used by the ECB and other central banks. This would reflect the actual credit quality of the bond issuer, and the bond's time to maturity.

- **Own-issued Bonds**

On a related point, the ECB and other central banks recognise own-issued covered bonds as collateral for repo transactions. At the EU level, repo eligibility of own-issued bonds is further recognised within the scope of the Capital Requirements Directive. We see no reason why the LCR buffer should not admit own-issued covered bonds in the same way. Similarly, in the NSFR required stable funding, own-issued bonds should be assigned the same coverage requirements as covered bonds issued by other institutions (these are currently set at 20% and 50%, depending on credit rating). As previously mentioned, covered bonds, in this case own-issued, are subject to special legislation with bankruptcy remoteness being a key feature. Given that the collateral is ringfenced, payments on the covered bond continue irrespective of a default of the issuer. This means that bonds can be actively traded even if the issuer is under bankruptcy procedures.

This distinctive feature, and the fact that issuing banks will acquire own covered bonds in the market in an act of market making and providing further liquidity, should on the contrary mean that own issued bonds are also included in a bank's stock of highly liquid assets.

We recommend the removal of the ineligibility of own-issued covered bonds in the calculation of highly liquid assets and required stable funding. Under the required stable funding calculation, own-issued covered bonds should be counted like all similar covered bonds.

- **Further conditionality on covered bond eligibility (bid-ask yield spread, historic price declines)**

We see little value in imposing an additional condition to test the size and depth of markets for covered bonds through bid-ask yield spreads and price declines. The supreme quality of covered bonds is already inherent in a history of zero defaults, and is further evidenced by the 60 billion euro purchase programme of the ECB. These additional tests appear superfluous, and from an administration point of view would require complex and costly processes to ensure compliance.

What is more, bid-ask-yield spreads are not the most appropriate tool for the measurement of the marketability of bonds, they are more representative of the trading intensity of a given security. Such trading intensity varies over the lifetime of a bond and declines considerably towards its maturity. In addition, such spread statistics are not always available for all outstanding covered bonds. Similarly, the proposed timelines, in the case of historic price declines covering 10 years, are simply not available in many cases.

While adding little value, these trigger levels could actually introduce instability in the market. A not unlikely scenario would be a firesale of highly liquid assets when a widening of the bid/offer spread is observed, and a closing in on the 40 or 50 bsp spread. These assets will be sold before reaching the trigger level, causing a drop in prices, widening the bid/ask spread and essentially creating a self-fulfilling prophecy.

We recommend the removal of further conditionality placed on covered bonds relating to bid-ask yield spread and historic price declines.

- **Net Stable Funding Requirement and required coverage for covered bonds**

In the NSFR, AAA to AA rated covered bonds are subject to a 20% coverage requirement which to us appears unjustified against the background of the high quality and good marketability of the instrument. We request to fully exclude them from any funding coverage requirements.

A-rated covered bonds are subject to a 50% coverage requirement which also appears excessive.

These requirements, along with the highly conservative haircuts and price testing, point to a liquidity parameter for a once in a century event. Transforming such parameters into a common rule seems to us an exaggerated response.

We recommend the exclusion of AAA to AA rated covered bonds from any funding coverage requirement. A-rated covered bonds should be subject to a lower coverage requirement than the currently proposed 50%.

- **Net Stable Funding Requirement and required coverage for mortgage loans**

Under required degree of coverage, mortgage loans (with the exception of those maturing within the year) would fall under ‘all other assets’ and as such be subject to a 100% coverage requirement.

We suggest that all retail loans, irrespective of final maturity should be included in the 85% bucket currently foreseen for retails loans with maturities of less than one year, so long as they are being repaid by regular instalments. This would better reflect the fact that these assets generate a partial cash flow throughout the year, and in some instances generate further cash flow with refinancing activity (redemptions).

For the required coverage calculation in the NSFR, we recommend the inclusion of all retail loans in the 85% bucket.

- **Net Stable Funding Requirement and eligibility of instruments with under one year maturities**

Returning to the earlier-made point that the proposal does not always take account of different business models, the suggested specifications under the NSFR provide a good example of this. Specialist mortgage lenders in a number of jurisdictions (Denmark, Germany, Ireland, Luxembourg and Sweden) pursue a match funding strategy or have to comply by law with specific liquidity provisions regarding the management of cover pools which effectively minimises or even eliminates liquidity risk. Under a match funding strategy, the payment of interest and principal on a loan is adjusted to the credit institution’s funding terms (interest and redemption of issued bonds), meaning that the credit institution incurs no liquidity risk.

Excluding covered bonds maturing within one year from the ‘stable funding available’ calculation would have severe consequences on specialist mortgage banks’ balance sheets, and would produce a large (albeit artificial) gap between available and required funding. Variable rate mortgages have gained in popularity recently with the historically low central bank rates, and these are the very assets underlying covered bonds with maturities of less than a year.

This is not to mention all the other covered bonds with varying maturities longer than one year, which at some point would be within one year of their maturities and thereby also excluded from the available funding metric.

We therefore propose an amendment to the NSFR definition to assign an availability factor of 100% to covered bonds irrespective of remaining term to maturity, subject to certain criteria being met (i.e. evidence of a match funding model or appropriate legislation minimizing liquidity risk.)

3. Leverage Ratio

The EMF understands, in theory, the appeal of a simple tool like the leverage ratio to limit unhealthy balance sheet growth. However we fear that in practice it quickly becomes not only a hindrance, but a major threat to long-established business models and to entire sectors of the banking system.

It is also worth recalling at this stage, that the financial crisis was primarily liquidity driven, with some of the most prominent examples of failures showing low leverage on their balance sheets. That is not to say that some banks have not been or are not possibly over-leveraged today. There should be a mechanism for national supervisors to be alerted to, for instance, a sudden change in leverage. But this is not the same as imposing a hard limit on all credit institutions on all types of business. In fact, we believe that it is of greater urgency to regulate those specific areas within the Basel II framework where it has been shown that risk was not measured in the proper way (liquidity risk, trading book.)

The concern, furthermore, is that a leverage ratio would not work as a complement to the Basel II framework as intended, but rather work in direct contradiction to the risk-based rules that credit institutions are otherwise supervised under. Mortgage lending is a low-risk activity, subject to preferential risk treatment under the Basel II/CRD framework. Financial institutions across Europe, whether specialist mortgage banks or commercial banks are prone to have a large exposure figure based on the low-risk residential mortgages part of their portfolio. For some business models, this goes even further as it encapsulates the entire asset-side of their balance sheet.

A leverage ratio as proposed, would discriminate against low risk, high volume business models, of which mortgage lenders and lenders to public authorities are prime examples. This would have major repercussions in the mortgage markets, constraining the availability of credit, and increasing the costs associated with the mortgage lending business. The restricted capacity to lend would be especially damaging in a post-crisis period when the demand for new loans is high and necessary for the restart of the economy. This is equally relevant to public sector lending where a leverage ratio would seriously impair the lending capacities of specialist banks.

Hence, not only does a leverage ratio threaten long-established business models which have proven resilient even through the financial crisis, it also creates incentives to reduce the balance sheet by increasing the risk profile. Without differentiation based on risk, higher profit-seeking through riskier assets would not be penalised. With a limited amount of equity, it would not be surprising if banks went after higher risk business.

From a global competiveness perspective, we also see a disproportionate impact on Europe where there is a large concentration of specialist mortgage banks. For instance, the specialist mortgage bank model is not present in the US where in any case US banks have yet to adhere to Basel II rules. It would be European banks that would have to bear the brunt of these measures. Given the important constraints identified above, the only sustainable option for a leverage ratio would be under Pillar II of the Basel framework. The focus would be on the development of a leverage position of a bank over time, and not a snapshot against a hard limit. Moreover, it is difficult to conceive of a fair calibration

which is comparable between banks using different models and from different countries. Under Pillar II the leverage ratio can be used more constructively to detect those institutions that have increased leverage significantly over a short period of time.

The EMF is strongly opposed to the introduction of a leverage ratio as a hard balance sheet limit. If a leverage ratio is deemed necessary in the present package of reforms, it should be included under Pillar II where it might add value without threatening to destabilize whole swathes of the European mortgage lending sector.

3.1 Capital measure

The most appropriate measure for going concern capital would be Total Tier 1 capital. The use of Core Tier 1 capital would force banks to issue new shares when in need of new capital. This would take too much time and it would also restrict the possibility to obtain capital from a wider range of investors. It would further be a strong disadvantage to non-listed joint stock companies that are unable to issue new shares.

3.2 Total exposure calculation

We strongly support the proposed notion to exclude high quality assets included in the Liquidity Coverage Ratio from the total exposure measure. We think this is absolutely necessary to maintain consistency between the liquidity section of the proposal and the section on the leverage ratio. A failure to exclude such assets from the exposure figure would reduce the propensity of banks to hold covered bonds in their liquidity buffer at all, striking at a very important source of mortgage funding in Europe. As argued in the previous section, the suggested conservative haircuts on covered bonds would only provide further disincentive from holding these instruments.

3.3 Netting

We strongly support the proposal to permit regulatory netting for repurchase transactions and securities lending transaction. Bearing in mind that specialist mortgage banks use derivatives as hedging instruments (asset liability matching), it is appropriate to recognise bilateral contractual netting agreements.

3.4 Accounting standards differences

Differences in accounting standards, US GAAP vs IRFRS, continue to pose a threat of competitive distortions where for instance netting systematically takes place under US GAAP.