ECBC

European Covered Bond Council

The Covered Bond Voice of the European Mortgage Federation

Basel Committee on Banking Supervision (BCBS) and Board of the International Organization of Securities Commissions (IOSCO) Consultative Document on Margin requirements for non-centrally-cleared derivatives

European Covered Bond Council (ECBC) Response

Brussels, 28 September 2012

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 created by the European Mortgage Federation (EMF) in 2004 to represent and promote the interests of covered bond market participants at international level. As of September 2012, the ECBC brings together over 100 members from more than 25 active covered bond jurisdictions. ECBC members represent over 95% of the €2.67 trillion outstanding covered bonds.

Introduction and General Remarks

The ECBC welcomes the opportunity to share with the BCBS and the IOSCO the views of the covered bond community on the initial policy proposals emerging from their joint Working Group on Margining Requirements (WGMR).

The ECBC is supportive of the goal of improving the resilience, transparency and efficiency of the OTC derivatives market by establishing minimum standards for margin requirements for non-centrally-cleared derivatives. The ECBC also welcomes the general objectives followed by the joint Working Group for this exercise to reduce systemic risk and promote central clearing.

However, we would like to seize the opportunity of this Consultative Document to highlight some important points concerning derivatives that are used for hedging purposes in covered bond transactions. We invite the joint Working Group, when drafting their final recommendations, to take into consideration the specificities of covered bond derivatives just as European Regulators have done in recitals 16[2] and 24[3] of the Regulation No 648/2012 of 4 July 2012 on OTC derivatives, CCPs and trade repositories (also called EMIR, please see here) which highlight the following points:

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

[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.

EMF

European Mortgage Federation aisbl

Avenue de Cortenbergh, 71 B-1000 Brussels - Belgium | Tel: +32 2 285 40 30 | Fax: +32 2 285 40 31 | TVA BE 411 583 173

emfinfo@hypo.org | www.hypo.org

➢ The specific provisions of covered bonds' legal frameworks that would unfortunately make derivatives in the cover pool of a covered bond ineligible to be cleared through a Central Clearing Counterparty (due to the fact that the derivative is designed to survive the insolvency of the issuing institution, whereas the standardised documentation requires that all derivatives be netted out at the time of the issuer's insolvency).

➢ The fact that in certain jurisdictions, collateral posting is unilateral, i.e. the issuer never posts collateral whereas the counterparty does when required.

Specific questions

Q3. Are there additional specific product exemptions, or criteria for determining such exemptions, that should be considered? How would such exemptions or criteria be consistent with the overall goal of limiting systemic risk and not providing incentives for regulatory arbitrage?

To recall, 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.

Almost all European covered bond legal frameworks allow derivatives in the cover pool with the purpose of hedging risks, essentially interest rate risks or currency mismatches, that may arise from the usual activity of an issuer, e.g. in case of USD denominated issuances, and from subsequent fluctuation of interest and foreign exchange rates.

These derivatives, which are mainly plain vanilla Cross Currency and Interest Rate swaps, are also designed to survive the issuer's insolvency. In such a case, the source of payment will switch to the cover pool and the covered bond holders will need the hedging effect of the derivatives to continue to mitigate the risks of the cover pool. Hence, common master agreements are adapted or supplemented in order to ensure that the insolvency of the issuer does not give the counterparty the right to terminate the derivative contract.

Most covered bond legislative frameworks in Europe also provide for a particular risk mitigation technique. Derivatives in covered bond cover pools are collateralised bilaterally but the collateral posting is unilateral – i.e. the counterparty posts collateral whereas the covered bond issuer does not. The counterparty has a preferential claim on the cover pool, ranking pari passu with the other covered bond holders, which fully compensates the necessity to collect collateral in order to mitigate the counterparty risk (both initial margin and variation margin). To recall, covered bond cover pools are constituted of very high quality assets which must fulfil restrictive legal requirements with regard to asset types, LTV, asset matching, etc. Unlike with securitisation, these assets remain on the issuer's balance sheet and the issuer has the obligation to ensure that the cover pool constantly meets the legal or regulatory requirements, in other words, to replace, if necessary, non-performing loans or prematurely paid debt. Therefore, we believe that the privileged access to the cover pool granted to covered bond swap counterparties offers an equal risk protection as initial and variation margins.

The ECBC believes that this specificity should be taken into account in the joint Working Group final recommendations and, thus, we invite the BCBS and IOSCO to include cover pools derivatives into the list

of products exempted from global margining requirements. We consider unilateral collateral posting for covered bond privileged derivatives as an accurate and appropriate exchange of collateral which is fully consistent with the overall goal of limiting systemic risk and not providing incentives for regulatory arbitrage. Lastly, we also believe that this particular risk mitigation technique should not be compensated by higher risk weightings which would be deemed unfair and would add unnecessary financial burden on this asset class which has turned out be vital for the European banking industry especially during financial turmoil.

Q20. Is the scope of proposed eligible collateral appropriate? If not, what alternative approach to eligible collateral would be preferable, and why?

The ECBC supports the inclusion of "high quality covered bonds" within the list of eligible collateral that satisfies the key principle presented in the consultative document (page 22). We welcome this recognition of covered bonds' consistently strong performance and quality features which have attracted the attention of regulators and market participants worldwide. This also acknowledges the high liquidity of this asset class as has also been acknowledged within the Recommendations of the BCBS (Basel III) and the CRD IV package proposed by the European Commission in July 2011 and currently under discussion at European level (please refer to the paper "Treatment of Covered Bonds in the Liquidity Coverage Ratios" available on the ECBC website, here).

This consultative document does not tackle the question of the acceptance as eligible collateral of financial instruments issued by the counterparty seeking to provide such collateral. We would like to stress here your support to the European Securities and Markets Authority (ESMA) approach in this regard. In its last consultation paper on "Draft Technical Standards for the Regulation on OTC Derivatives, CCPs and Trade Repositories" published on 25 June 2012, ESMA proposed that "*clearing members should not in general be permitted to use their own securities or securities issued by an entity from the same group as collateral*" (Recital 51, page 79). However, EMSA acknowledged the excellent track record and safety mechanisms of covered bonds, introducing an exemption for this asset class: "*a CCP should be able to allow clearing members to post covered bonds that are insulated from the insolvency of the issuer. The underlying collateral should nevertheless be appropriately segregated from the issuer and satisfy the minimum criteria for acceptable collateral*".

As mentioned above, covered bonds represent a claim against the issuer in the first place and, additionally, a full recourse to a cover pool of high quality assets in case of issuer default. In other words, covered bonds are designed to survive the insolvency of the issuer. If a covered bond issuer defaults or becomes insolvent, its covered bonds will not be accelerated and will be redeemed in accordance with the original terms of issuance. This is perhaps one of the most important features of covered bonds and this plays an important role in their recognition and success. Therefore, the ECBC believe that the potential prohibition of financial instruments issued by the counterparty as collateral should not apply to covered bonds given their bankruptcy remoteness and that it is appropriate to accept owned name covered bonds as collateral.

> Q21. Should concrete diversification requirements, such as concentration limits, be included as a condition of collateral eligibility? If so, what types of specific requirements would be effective? Are the standardised haircuts prescribed in the proposed standardised haircut schedule sufficiently conservative? Are they appropriately risk sensitive? Are they appropriate in light of their potential liquidity impact? Are there additional assets that should be considered in the schedule of standardised haircuts?

The ECBC believes that the proposed haircuts are sufficiently conservative. However, we would like to invite the WGMR to introduce more granularity here as the matrix presented in Appendix B (Proposed Standardised Haircut Schedule, page 33) only differentiates between three maturity buckets which are: maturity less than 1 year, residual maturity between 1 and 5 years, residual maturity greater than 5 years. We believe that additional granularity would allow a better risk calibration and would be more appropriate. To this aim, we encourage the joint Working Group to recommend haircuts that would be consistent with those applied to covered bonds by the European Central Bank for repo transactions.

> Q25. Are the proposed requirements with respect to the treatment of non-centrally-cleared derivatives between affiliated entities appropriate? If not, what alternative approach would be preferable, and why? Would giving local supervisors discretion in determining the initial margin requirements for non-centrally-cleared derivatives between affiliated entities result in international inconsistencies that would lead to regulatory arbitrage and unlevel playing field?
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> Q26. Should an exchange of variation margin between affiliates within the same national jurisdiction be required? What would be the risk, or other, implications of not requiring such an exchange? Are there any additional benefits or costs to not requiring an exchange of variation margin among affiliates within the same national jurisdiction?

The ECBC welcomes the decision of the WGMR to leave initial margin requirements to national discretion as this will allow some covered bond issuers to cope with certain legal impediments that might exist in their respective countries. Indeed, in some jurisdictions, the covered bond legal framework prohibits the posting of initial margins.

However, we invite the joint Working Group to extend the exemption mentioned above to intra-group transactions and to allow unilateral collateral posting for variation margins when the transaction involves a covered bond issuer. We believe that it would otherwise create an unnecessary liquidity burden that would jeopardize the whole asset class.

Related issues

We would like to draw the attention of the joint Working Group to the use, in certain jurisdictions, of a specific risk mitigation technique for derivatives, in which a replacement mechanism exists. This provides that the counterparty would be replaced automatically should its rating fall below a certain level. This trigger system is deemed appropriate and consistent with the overall goal of limiting systemic risk by national regulators. Therefore, we believe that this specific risk mitigation technique should be carefully considered as well as the impact in terms of liquidity that new requirements could have on those issuers.