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)

Second Consultative Document Margin requirements for non-centrally cleared derivatives

European Covered Bond Council (ECBC) Response

Brussels, March 2013

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 March 2013, 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 comment on this second consultative paper which presents a near-final proposal on margin requirements for non-centrally-cleared derivatives. The covered bond industry is supportive of the efforts made by the BCBS and IOSCO to further improve "*transparency and regulation of OTC derivatives and participants in the OTC derivatives markets*" so as to "*limit excessive and opaque risk-taking through OTC derivatives and to reduce the systemic risk posed by OTC derivatives transactions, markets, and practices".*

The ECBC also welcomes the efforts made to manage the liquidity impact of the margin requirements on financial market participants. In this paper, the BCBS and IOSCO recognise that "*under current market practices, the exchange of two-way initial margin in bilateral trades is not universal. Accordingly, requiring the segregation or other protection of initial margin collateral may create material incremental liquidity demands and trading costs relative to current practices".*

However, it appears that, in this second discussion paper, the BCBS and IOSCO favour a mandatory exchange of both initial and variation margins among parties to all non-centrally cleared derivatives which would represent a major concern for the covered bond industry. We believe that this "universal two-way margin" for non-centrally cleared derivatives represents a one-size-fits-all solution which could have severe consequences on the covered bond market. Liquidity and cash management is a major issue for covered bond issuers and we doubt that the tools that would potentially be put in place (margin threshold and phase-in implementation in particular) would satisfactorily compensate the operational and logistical challenges that these new requirements represent.

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

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

In this respect, and following our response to your first consultation paper sent on 28 September 2012, we invite the BCBS and IOSCO, 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).

In particular, in Recital 24 of EMIR, European regulators have deemed important to highlight the fact that in certain jurisdictions, collateral posting is unilateral, i.e. the issuer never posts collateral whereas the counterparty does when required. Therefore, we urge the BCBS and the IOSCO to take into careful consideration this risk mitigation technique in their final paper which could otherwise have serious implications for the covered bond market and for the European banking industry in particular.

Use of derivatives in covered bond transactions and impediments to central clearing

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 qualify the counterparty to terminate the derivative contract.

Covered bond issuers have approached CCPs in order to discuss whether cover derivatives could be cleared through the latter (CCPs). However, at present, CCPs are unable to differentiate between the derivative contracts of the insolvent issuing bank and those of the covered bond cover pool. Derivatives within the cover pool would then be automatically terminated in the event of default of the covered bond issuer.

Furthermore, covered bond legislative frameworks in Europe provide for a particular risk mitigation technique. As described below in more details, collateral posting for cover pool derivatives is unilateral; the counterparty benefiting from a preferential claim over the cover assets. Unfortunately, this technique does

---

[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.

not fit central clearing systems which require bilateral exchange of collateral and, therefore, impedes these privileged derivatives used for covered bond hedging purposes from being cleared through CCPs.

Risk mitigation technique used for derivatives that are used for hedging purposes in covered bond transactions

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).

Covered bond cover pools are indeed 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. Covered bonds have long proven to be exceptionally low risk financial instruments which are governed by strict supervisory and regulatory frameworks in Member States, which also helps to ensure their exceptional safety characteristics. Coupled with the related investor confidence, covered bonds have proved to be a safe harbour during financial crises and share, in terms of ratings stability and default history, many characteristics with government bonds. 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.

Additionally, in certain jurisdictions, 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.

Hence, we urge the BCBS and IOSCO to duly take into account the impediments faced by covered bond issuers or cover pools in providing collateral in a number of EU jurisdictions and to recognize unilateral collateral posting for covered bond privileged derivatives as an accurate and appropriate exchange of collateral as acknowledged by the European legislators in Recital 24[4] of EMIR.

Higher Capital Charge

Last but not least, the exclusion from central clearing for OTC derivatives which are concluded with covered bond issuers or with covered bond cover pools is due to legal and technical provisions that impede central clearing of such derivative transactions. We believe that this technical exclusion does not increase the risk profile of these derivatives and 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.

More generally, we consider that margin and capital, although different tools (the former is "defaulter-pay" and is more "targeted" and dynamic, the latter is "survivor-pay" and shared collectively by all the entity's

[4] "[…] *preferential claims given to covered bond issuers counterparties on the covered bond issuer's assets provides equivalent protection against counterparty credit risk"*

activities), are both aimed at adding loss absorbency in the system and mitigating the counterparty risk which might arise from derivatives and swap transactions. As far as non-centrally cleared derivatives are concerned, we understand that European and international regulators are working to put in place techniques which will appropriately mitigate the counterparty risk. Therefore, in those cases, putting in place both instruments would be redundant and would be an unnecessary burden increase for financial institutions, especially in the context of sharp rise of liquidity and capital requirements.

Related Issues

In its fourth Key Principle, the BCBS and IOSCO proposed that, in order to avoid so called "wrong way risk", securities issued by the counterparty or its related entities should not be accepted as collateral. The ECBC welcomes the BCBS and IOSCO efforts to avoid collateral with a significant correlation with the creditworthiness of the counterparty. However, we consider that the BCBS and IOSCO should avoid having a one-size-fits-all approach in this regard and should consider the inclusion of own-named covered bond as eligible 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, given their bankruptcy remoteness, we consider that it is appropriate to accept owned name covered bonds as collateral as already acknowledged by ESMA in its Final Report: *Draft technical standards under the Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC Derivatives, CCPs and Trade Repositories*[5].

[5] "*To avoid wrong-way risk, clearing members should not, in general, be permitted to use as collateral their own securities or securities issued by an entity from their same group. However, 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 of collateral. A clearing member should not issue financial instruments for the primary purpose of using them as collateral by another clearing member.*"