EMF/ECBC Response to the BCBS regarding the proposed Supervisory Framework for Measuring and Controlling Large Exposures

Brussels, 28 June 2013

1. Introduction

The European Mortgage Federation (EMF) and the European Covered Bond Council (ECBC) welcome the opportunity offered by the Basel Committee on Banking Supervision (BCBS) to comment on its proposed supervisory framework for measuring and controlling large exposures.

The EMF / ECBC would like to reiterate their support for the BCBS' efforts to take on board the lessons from the financial crisis and, in particular, to improve the way banks measure, aggregate and control exposures to single counterparties across their books and operations in order to avoid that a bank could fail due to concentrated exposures to individual counterparties as has occurred in the past. In this regard, the large exposures regulation has been developed as a tool to: (i) contain the maximum loss a bank could face in the event of a sudden counterparty failure to a level that does not endanger the bank's solvency; and (ii) ensure that this loss will not have systemic consequences for global financial stability.

However, the EMF / ECBC are concerned about the potential and significant impact that the proposed measures could have on the European covered bond and mortgage markets. In this respect, we would like to draw the attention of the BCBS to a number of points that we deem important to be taken into account in the final version of its supervisory framework for measuring and controlling large exposures.

2. Covered bonds: macro-prudential features

Covered bonds are one of the key components of European capital markets with the asset class playing an important role as a robust long-term financing instrument contributing to the efficient allocation of capital and, ultimately, economic development and prosperity. Under the prevailing adverse market conditions, covered bonds have proved to be the most reliable wholesale funding source, significantly contributing to overall financial stability.

To recap, covered bonds are dual recourse debt instruments issued by credit institutions (the covered bond issuer) and secured by a cover pool of financial assets. This collateral is constituted of very high quality assets, typically mortgage loans or public-sector debt, which must fulfil restrictive legal requirements with regard to asset types, LTV, asset matching, etc. In this regard, covered bonds play an important role in financing long-lived capital in Europe and in investments with a wide public benefit.

Covered bonds have long proven to be exceptionally low-risk financial instruments which are governed by strict supervisory and regulatory frameworks, which also help 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 many characteristics with government bonds in terms of rating stability and default history.

Unlike with securitisation, these assets remain on the issuer's balance sheet ("skin-in-the-game") and the issuer has the obligation to ensure that the cover pool constantly meets the legal and/or regulatory requirements, in other words, to replace, if necessary, non-performing loans or prematurely paid debt. This has been clearly identified, from a macro-prudential perspective, as an efficient and simple alternative to complex originate-to-distribute products and, therefore, as a key driver for a virtuous cycle in managing risks and ensuring financial stability.

From an issuer's perspective, covered bonds provide a significant contribution to the enhancement of a bank's funding profile and the management of its liquidity. Benefits provided by covered bonds include:

1) extending the maturity profile of the liabilities, allowing banks to better match their long-term asset portfolios;
2) providing stability to the funding mix, allowing Asset Liability Management (ALM) teams to increase predictability in the maturity profiles;
3) enabling issuers to increase diversification in the investor base, both in terms of geography and investor type;
4) securing loan assets which are otherwise illiquid assets (e.g. mortgage loans) and thereby improving the liquidity of bank balance sheets; and
5) serving the Industry as one of the most reliable funding tools, even in times of turmoil.

In the context of financial turmoil, as is currently the case, covered bond assets also actively contribute to restore investors' confidence in the European banking system. From an investor's perspective, the major strengths and regulatory advantages of covered bonds can be summarised as follows:

1) double recourse to issuer and cover pool;
2) higher rating and higher rating stability than unsecured debt;
3) lower-risk weighting for EEA Covered Bonds bought by EEA banks;
4) favourable treatment under Solvency II;
5) generally better liquidity through larger issue size;
6) favourable repo treatment at the European Central Bank (ECB) and other central banks;
7) eligible as liquid assets under upcoming Basel III rules; and
8) no risk of bailing-in.

This explains the success of covered bonds which, for two and a half centuries and through many crises, have played an increasingly important role in the financing of real estate, public sector and ship assets. With over EUR 2.67 trillion outstanding at the end of 2011, covered bonds continue, now more than ever, to play a central role in banks' funding strategies. The EUR 695 billion issuance and the arrival of 30 new issuers during 2011 for a total of more than 300 issuers in more than 25 EU Member States evidence the ability of the asset class to provide essential access to long-term capital market funding, even during volatile market conditions, notably thanks to a stable investor base.

Therefore, we are seeing new issuers enter the market and new covered bond frameworks being established in many countries around the world. Moreover, covered bonds' consistently strong

performance and quality features have attracted the attention of regulators and market participants worldwide, which, in turn, has led to an increasing recognition of the macro-prudential value of the asset class.

Covered bonds in the large exposures regime: discussion

Against this background, we believe it is necessary to preserve this fundamental asset class and to ensure that the impact of the proposed supervisory framework will not be detrimental to those European issuers for which covered bonds play a crucial role in their funding activities.

In particular, the Industry is concerned that the supervisory framework in the consultation document does not reflect the characteristics of covered bonds. We would like, *inter alia,* to emphasise the link between the large exposures framework and the LCR. The LCR requirements will put covered bonds in the centre of liquidity management of credit institutions worldwide and covered bonds will represent a significant part of banks' liquidity buffers in the future. If the large exposures framework requires credit institutions to add up covered bonds held in the liquidity buffers, the 25% limit would easily be exceeded because of the relatively small number of issuers. This could lead to detrimental impacts on the liquidity buffers.

Furthermore, we would like to draw the BCBS' attention to markets located in small currency areas where only a limited number of covered bond issuers are active. For these markets, the proposed framework could introduce new constraints for investors and banks on how they constitute their liquid reserves, and meet the new liquidity requirements. Ultimately this could lead to a lowering of the supply of liquid assets in the domestic currency and the proper functioning of their covered bond market. The higher capital costs for holding the sufficient liquidity buffer - particularly in light of the small government debt markets in these countries - would also create competitive disadvantages for banks in these countries when competing against banks operating internationally.

The EMF / ECBC therefore call for a full or partial exemption of covered bonds from the large exposure limits.

3. Physical collateral

The EMF / ECBC are seriously concerned about the proposed complete ban on the recognition of physical collateral, which is considered excessively far-reaching. In a number of countries in Europe, there is a longstanding tradition of funding economic needs through loans secured by mortgages on commercial or residential property, including loans to small and medium sized entities (SMEs), which are typically secured by business premises. In addition, if a conservative valuation is applied and demanding qualitative criteria in line with the supervisory requirements are met, residential and commercial real estate constitutes sound and stable value collateral, which will be realisable should a client default, thereby resulting in increased liquidity based on real property transactions in real estate markets.

The Basel Rules themselves envisage such stringent requirements for commercial real estate financing, under the condition that they are privileged for solvency purposes. Consequently and in line with this approach, only real estate will be acceptable collateral if it pertains to markets, the stability of which has been confirmed during so-called hard tests (i.e. the collection of maximum loss ratios). In Europe, the implementation (under the CRR / CRD IV) of this rule will become even

more stringent: for instance, hard testing will not only be applied to commercial real estate financing but also to residential real estate loans and it will also be a decisive criteria for a privileged treatment in the large exposure rules. Furthermore, only certain real estate types will be eligible collateral.

The EMF / ECBC therefore call for the recognition of both commercial and residential real estate as collateral in the large exposure regime, which (provided that strict requirements are met) prove to be adequately risk sensitive.

Furthermore, it is important to point out that a ban on the eligibility of real estate collateral may result in changes in funding structures. For instance, for a number of banks it may become impossible to initiate a syndicate to finance high volume real estate transactions or larger projects related to infrastructure due to the fact that the exposure volume would require full recognition in a first step. Only very large banks would be able to fulfil this role resulting in systemic concentrations. Indeed, the forthcoming ineligibility of real estate collateral would seriously restrict the lending decisions of smaller banks, which in any case would quickly reach their limits when financing larger real estate transactions, due to the plans to restrict eligible capital to Tier 1 (potentially even to CET1).

In this context, the rationale behind the discrimination of a certain type of collateral is unclear. Hence, the EMF / ECBC recommend that the scope for recognition of physical collateral is expanded in the forthcoming proposals.

Background note:

The EMF[1], which represents 78% of the EU mortgage industry, is the voice of the mortgage industry in the EU on both the retail and funding sides of the business. The mortgage industry is a major driver of the general EU economy and has an important role in turning the European economy towards a growth path. At the end of 2012, outstanding mortgage loans amounted to €6.5 trillion, which is equal to 51.7% of EU GDP.

The European Covered Bond Council (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 international level. As of June 2013, the ECBC brings together 100 members from more than 25 active covered bond jurisdictions. ECBC members represent over 95% of the €2.67 trillion outstanding covered bonds.

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

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