



ESA Joint Discussion Paper on Draft Regulatory Technical Standards on risk mitigation techniques for OTC derivatives not cleared by a CCP under the Regulation on OTC derivatives, CCPs and Trade Repositories

European Covered Bond Council position

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 2012, the ECBC brings together over 110 members from more than 25 active covered bond jurisdictions. ECBC members represent over 95% of the €2.5 trillion outstanding covered bonds.

Introduction

The European Covered Bond Council (ECBC) supports the goal of improving the resilience, transparency and efficiency of the OTC derivatives market and welcomes the effort of European regulators to take into account the specificities of covered bonds as stated within recitals 12 and 14 of the Regulation of the European Parliament and Council on OTC derivatives, central counterparties and trade repositories as agreed at the Trilogue meeting of 9 February 2012.

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. This includes both intragroup transactions and swaps with external counterparties.

These derivatives, which are mainly plain vanilla Cross Currency and Interest Rate swaps, are designed to survive the issuer's insolvency as is the case for covered bond cover pools. In most jurisdictions, the cover pool will become the swap counterparty in case of issuer insolvency. As there is no acceleration of the covered bonds, the covered bondholders will continue to need the hedging effect of the derivatives to continue to mitigate the interest rate or currency 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 entitle the counterparty to terminate the derivative contract.

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

In recitals 12² and 14³, European regulators have considered that two specificities should be taken into account when establishing the draft technical implementation measures:

- 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). Please refer to the ECBC response to the Discussion Paper on Draft Technical Standards for the Regulation on OTC Derivatives, CCPs and Trade Repositories for further information ([here](#)).
- The fact that in certain jurisdictions collateral posting is unilateral, i.e. the issuer never posts collateral whereas the counterparty does when required.

Unilateral collateral posting

Derivatives in the cover pool 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 bondholders, 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.

An obligation to post collateral bilaterally would constitute a second level of privilege and represent an illegitimate benefit for the counterparty which ranks *pari passu* with the covered bondholders, already benefits from a legal privilege and has access to the cover pool of high quality assets in case of issuer default. In some jurisdictions, it is even legally not possible for covered bond cover pools to post initial or variation margins vis-à-vis its derivative counterparties as collateralisation is already provided by claims against the cover pool.

Therefore, in determining *"accurate and appropriate exchange of collateral to manage risks associated with uncleared trades"*, we invite ESMA to take into account this particular feature of hedging derivatives used within covered bond cover pools and to maintain unilateral collateral posting for covered bonds which model is imposed by national legal provisions and meets the higher risk mitigation standards.

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 12

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 legal privilege given to covered bond issuers counterparties on the covered bond issuer's assets provides equivalent protection against counterparty credit risk"*, Recital 14.