

European Covered Bond Council Response to ESMA Consultation Paper

Draft Technical Standards for the Regulation on OTC Derivatives, CCPs and Trade Repositories

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 July 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

We would like to thank the European Securities and Markets Authority (ESMA) for giving the industry the opportunity to present its views regarding the forthcoming Technical Standards for the Regulation No 648/2012 of 4 July 2012 on OTC derivatives, CCPs and trade repositories (also called EMIR, please see [here](#)) to be developed in accordance with the legislative mandates of EMIR.

The ECBC is supportive of 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. In recitals 16² and 24³, European regulators have indeed 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).
- The fact that in certain jurisdictions collateral posting is unilateral, i.e. the issuer never posts collateral whereas the counterparty does when required.

We would like to seize the opportunity of this Consultation Paper to highlight some important points concerning ESMA implementation of the two recitals above and to present the ECBC's views regarding the inclusion of own name covered bond as eligible collateral and the proposed investment policies for CCPs.

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.

1-Exemption of covered bond derivatives from clearing obligation (Recital 16 of EMIR)

The ECBC welcomes the effort of European regulators to take into account the specificities of covered bonds' legal frameworks which would unfortunately make derivatives in the cover pool of a covered bond ineligible to be cleared through a Central Clearing Counterparty (CCP). Recital 16 of the Regulation on OTC Derivatives, CCPs and Trade Repositories calls for an exemption of derivatives used in the covered bond cover pools from central clearing obligation.

We would like to invite ESMA to also take into account the legal and technical obstacles faced by issuers of covered bond when establishing its technical standards and to confirm the exemption of covered bonds from central clearing obligations.

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 above, collateral posting for cover pool derivatives is unilateral; the counterparty benefiting from a preferential claim over the cover assets. Unfortunately, this technique does 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.

Therefore, in determining the classes of derivatives subject to the clearing obligation, we urge ESMA to allow special treatment for derivatives used within covered bonds' cover pool where legal and technical provisions impede central clearing of the derivative transaction. We also believe that this exemption would not increase the risk profile of these derivatives and should not be compensated by higher risk weightings.

2-Risk mitigation techniques for OTC derivatives not cleared by a CCP & unilateral collateral posting (Recital 24 of EMIR)

We understand, as stated in the Consultation Paper, that the questions of risk mitigation techniques for OTC derivatives that are not cleared by a CCP and of capital requirements and exchange of collateral (margins for bilateral transactions) are not covered under this consultation paper.

However, we believe it is important to highlight that derivatives in covered bond cover pools are collateralised bilaterally but that 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.

Hence, we urge ESMA 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 consider unilateral collateral posting for covered bond privileged derivatives as an accurate and appropriate exchange of collateral. 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 to be vital for the European banking industry especially during financial turmoil.

3-Own name covered bond to be included as eligible collateral (Article 46 of EMIR)

Following on from Article 46(3) of the EMIR Regulation, *“ESMA shall, after consulting, EBA, the ESRB and the ECSB develop draft regulatory technical standards specifying (a) the type of collateral that could be considered highly liquid, such as cash, gold, government and high-quality corporate bonds, covered bonds; (b) the haircuts and (c) the conditions under which commercial bank guarantees may be accepted as collateral”*.

The ECBC agrees with the ESMA position as summarised within paragraph 200 and 201 (page 37) of the Consultation Paper and with the proposed wording for the draft Regulatory Standards as presented in the Annex III - Draft regulatory technical standards on CCP requirements (Recital 51, page 79).

The ECBC supports the inclusion of covered bonds within the list of assets accepted as collateral by a CCP. Covered bonds' consistently strong performance and quality features have attracted the attention of regulators and market participants worldwide which, in turn, led to an increasing recognition of the macro prudential value of this asset class. The high liquidity of this asset class has already been acknowledged within the Recommendations of the Basel Committee (Basel III) and the CRD IV package proposed by the European Commission in July 2011 and currently under discussion at European level.

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 concurs that the proposed criteria regarding a CCP not accepting as collateral financial instruments issued by the clearing member should not apply to covered bonds given their bankruptcy remoteness and that it is appropriate to accept owned name covered bonds as collateral by the clearing members.

4-Investment policies for CCPs (Article 47 of EMIR)

Following on from Article 47(8) of the EMIR Regulation, *"ESMA shall, after consulting EBA and the ESCB, develop draft regulatory technical standards specifying the financial instruments that can be considered highly liquid, bearing minimal credit and market risk, the highly secured arrangements for the deposit of cash and financial instruments and the concentration limits"*.

The ECBC believes that covered bonds should be included within the definition of highly liquid financial instruments with minimal market and credit risk, considering the excellent track record of this asset class.

The strong supervision of and the underlying regulatory and legislative framework of governing covered bonds, designed to properly assign collateral in case of resolution, have attracted over the years a broad and stable investor base. This has enabled covered bonds to perform strongly over the past number of years and even in times of stress, as witnessed during the recent financial turmoil where covered bonds have performed similarly to sovereign bonds in terms of credit risk, volatility and liquidity (please refer to the [European Covered Bond Council Factbook 2011](#) for more details).

Therefore, we invite ESMA to consider a proper recognition of this asset class to fully reflect their safety features, i.e. dual recourse, high quality assets cover pool with strong supervision, excellent track record and resilient nature. In light of these factors, we urge ESMA to include covered bonds within the definition of highly liquid financial instruments in which a CCP shall invest its financial resources.