



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

Reponse from the European Covered Bond Council

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

Executive Summary

- The ECBC supports the special treatment of hedging derivatives within covered bond cover pools with regard to the clearing obligation as specified in Recital 12 of the Regulation on OTC Derivatives, CCPs and Trade Repositories.
- When establishing appropriate exchanges of collateral, the ECBC calls on the European Securities and Markets Authority (ESMA) to take into account the legal and technical obstacles faced by covered bonds issuers and in particular the unilateral collateral posting as provided by law in certain European jurisdictions.

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



- *Question 7: What are your views regarding the specifications for assessing standardization, volume and liquidity, and availability of pricing information?*

The European Covered Bond Council (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' 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). In order to address this issue, Recital 12² states that ESMA should "*take into account the specific nature of OTC derivatives which are concluded with covered bond issuers or with cover pools for covered bonds*". Therefore, we would like to draw your attention to the specific use and format of hedging swaps that are currently used in covered bond cover pools.

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 which case, the source of payment will switch to the cover pool and the covered bondholders 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.

Another issue in certain jurisdictions is that collateral posting is unilateral, i.e. the issuer never posts collateral whereas the counterparty does when required. The reason for this provision is that the counterparty, which ranks *pari passu* with the covered bondholders, already benefits from a legal privilege

² This Regulation sets out the criteria for determining whether or not different classes of OTC derivatives should be subject to a clearing obligation. On the basis of draft implementing technical standards developed by ESMA, the Commission should decide whether a class of OTC derivatives should be subject to a clearing obligation, and from when the clearing obligation takes effect including, where appropriate, phase-in for any frontloaded contracts, the minimum remaining maturity of the contracts to be frontloaded, and any gradual implementation of the clearing obligation which could be in terms of the types of market participants that must comply with the clearing obligation. 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.

and has access to the cover pool. Collateral posting by the issuer would constitute a second level of privilege, which is not legally possible.

Therefore, in determining the classes of derivatives subject to the clearing obligation, we invite ESMA to allow special treatment for derivatives used within covered bonds cover pool where legal provisions impede central clearing of the derivative transaction. Because of the supplements to the underlying master agreement implementing the bankruptcy remoteness clause or, in certain cases, unilateral collateral posting required by the legal provisions for covered bonds, the currency and interest rate hedging swaps used in cover pools could technically not be clear through a CCP.

- *Question 45: In respect of the proposed criteria regarding a CCP not accepting as collateral financial instruments issued by the clearing member seeking to lodge those financial instruments, is it appropriate to accept covered bonds as collateral issued by the clearing member?*

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, has 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 and be redeemed according to their original terms of issuance. 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. This is perhaps one of the most important features of covered bonds and plays an important role in their recognition and success. Therefore, the ECBC believes 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 covered bonds as collateral by the clearing members.

- *Question 51: Do you consider that financial instruments and cash equivalent financial instruments which are highly liquid with minimal market and credit risk have been rightly identified? Should ESMA consider other elements in defining highly liquid financial instruments with minimal market and credit risk? What should be the timeframe for the maximum average duration of debt instrument investments?*

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. Covered bonds also comply with the criteria listed under item 135 of this Discussion Paper, except for point (vii) (debt instrument issued or guaranteed by a government, central bank or multilateral development bank).

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 years and



even in times of stress, as witnessed during the recent financial turmoil where covered bonds had shown performance close 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 higher recognition of this asset class to fully reflect their safety features, i.e. dual recourse, high quality assets cover pool and strong supervision, their excellent track record and their resilience and to include covered bonds within the definition of highly liquid financial instruments in which a CCP shall invest its financial resources.