

EBA Op/2017/06

11 April 2017

Opinion of the European Banking Authority on the partial waiver of Article 129(1)(c) of the CRR

Introduction and legal basis

The EBA competence to deliver an opinion is based on Article 29(1)(a) of Regulation (EU) No 1093/2010¹, which relates to the EBA's area of competence by virtue of Article 129(1) third subparagraph of Regulation (EU) No 575/2013 (CRR)².

Article 129 of the CRR specifies the conditions for the eligibility of covered bonds in relation to risk weight preferential treatment, including the assets by which eligible covered bonds can be collateralised. Article 129(1)(c) specifies that eligible covered bonds can be collateralised by exposures to institutions that qualify for the credit quality step (CQS) 1 as specified in Part Three, Title II, Chapter 2 of the CRR. The total exposure of this type must not exceed 15% of the nominal amount of outstanding covered bonds of the issuing institution. Exposures to institutions in the Union with a maturity not exceeding 100 days shall not be comprised by the CQS 1 requirement but those institutions must at least qualify for CQS 2 as specified in Part Three, Title II, Chapter 2 of the CRR.

The third subparagraph of Article 129(1) specifies that the competent authorities may, after consulting the EBA, partially waive the application of Article 129(1)(c) and allow instead CQS 2 for up to 10% of the total exposure of the nominal amount of outstanding covered bonds of the issuing institution. This applies only if significant potential concentration problems in the Member States concerned can be documented due to the application of the CQS 1 requirement referred to in that point.

¹ Regulation (EU) No 1093/2010 of the European Parliament and of the Council of 24.11.2010 establishing a European Supervisory Authority (European Banking Authority) amending Decision No 716/2009/EC and repealing Commission Decision 2009/78/EC (OJ L 331, 15.12.2010, p. 12).

² Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26.6. 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 (OJ L 176, 27.6.2013, p. 1).

On 07 October 2016, the Polish Financial Supervisory Authority (*Komisja Nadzoru Finansowego – KNF*) submitted to the EBA a notification of its intention to partially waive Article 129(1)(c) of the CRR, together with the relevant supporting documentation justifying that intention.

In accordance with Article 14(5) of the Rules of Procedure of the Board of Supervisors³, the Board of Supervisors has adopted this opinion.

General comments

1. Having given consideration to the information provided by the Polish Financial Supervisory Authority, with reference to the date of the notification (October 2016):
 - (a) on the current classification of Polish institutions in relation to the CQSs assigned on the basis of external credit ratings, whereby only six institutions operating in Poland currently classify as CQS 1;
 - (b) on the current composition of the Polish covered bond market and on the characteristics of the Polish covered bond regime;
 - (c) on the type and nature of exposures to institutions that covered bonds regularly assume;

and based on that information, the EBA is of the opinion that there is sufficient material to support the view that there is a significant potential concentration problem in Poland stemming from the application of the CQS 1 requirement specified in Article 129(1)(c) of the CRR. This has the potential to result in prudential concerns and concerns related to the degree of competition in the financial market.

Specific comments

Assessing a significant potential concentration problem

2. The EBA assesses the significant potential concentration problem within the jurisdiction that is submitting the notification of partial waiver and takes into account several factors, including but not limited to the following:
 - (a) the nature of exposures to institutions that covered bonds assume in that jurisdiction;
 - (b) the magnitude of exposures to institutions that covered bonds assume in that jurisdiction;
 - (c) the number of institutions to which a CQS 1 is being assigned at the time of consideration by any of the External Rating Agencies registered/certified with ESMA (at least by any of the large/internationally active ECAIs);
 - (d) the scope of business activities of those institutions to which a CQS 1 is being assigned;
 - (e) other potential jurisdiction-specific considerations related to institutions in that jurisdiction;
 - (f) potential additional eligibility conditions set by the national covered bond regime on exposures to institutions, beyond the CQS 1 criterion;
 - (g) an assessment of the expected impact of granting vs. not granting the partial waiver on Article 129(1)(c) of the CRR within the applicant jurisdiction;

³ Decision adopting the Rules of Procedure of the European Banking Authority Board of Supervisors of 11.12.2013 (Decision EBA/DC/001 (Rev 3)).

- (h) other general considerations, where appropriate.
3. The EBA considers different forms of exposures to institutions that may arise within a covered bond programme, including but not limited to the following forms of exposures:
- (a) exposures arising from the use of bank account facilities;
 - (b) exposures arising from derivative contracts entered into with institutions, i.e. where the institution is the counterparty of the covered bond issuer/covered bond programme within the derivative contract;
 - (c) exposures arising from the use of instruments issued by institutions as substitution/complementary assets within the covered bond programme;
 - (d) exposures arising from the use of liquidity facilities.
4. As regards point (b), the EBA is of the view that exposures arising from derivative contracts entered into with institutions are to be taken into account for determining compliance with CRR Article 129(1)(c) unless either of the following conditions is met:
- (a) the national covered bond legal/regulatory framework or the national supervisory regime are such that the value of derivative instruments is not taken into account when determining compliance with the minimum nominal coverage requirement;
 - (b) the derivative constitute additional collateral over and above the minimum required collateral to meet the nominal coverage requirement set out in the national legal/regulatory framework for the protection of the bondholder⁴.
5. The EBA is also of the view that whenever the national covered bond legal/regulatory framework provides for a pari passu ranking of the liabilities arising from derivatives included in cover pools with respect to the liabilities towards covered bond investors, the minimum nominal coverage requirement established by Article 52(4) of Directive 2009/65/EC should at all times also apply to the liabilities arising from the derivatives. The latter include any exposure value arising from negative (i.e. out of the money) market value of derivatives included in the cover pool.
6. As part of the information provided by the national competent authority notifying the partial waiver, a clear illustration must be provided of the CRR provisions with which the exposures considered in the assessment of the concentration can be classified as exposures to institutions.

The concentration problem in Poland

7. Based on the information provided by the Polish Financial Supervisory Authority, the EBA understands that covered bond programmes established in the jurisdiction's covered bond regime assume exposures to institutions mostly (although not exclusively) in the following set

⁴ Consistently with the answer provided by the European Commission to question number 223 published on 24 May 2007 in the context of the CRD Transposition Group (CRDTG), related to Annex VI, Part 1, point 68 (c) of Directive 2006/48/EC. These provisions remained unchanged with the introduction of the CRR. See: http://ec.europa.eu/internal_market/bank/docs/regcapital/transposition/answers48_en.pdf

of circumstances. Covered bond issuers are explicitly requested by the Polish covered bond legislation⁵ to mitigate foreign currency risk in case of currency mismatches arising from the issuance of covered bonds. The law also prescribes that banks may mitigate interest rate risk arising from the issuance of covered bonds. In order to mitigate such risks banks enter into transactions in derivative contracts, mostly using cross-currency swaps.

8. As submitted by the Polish Financial Supervisory Authority, as of 30 June 2016, there were six institutions operating in Poland with an external credit rating qualifying them to be CQS 1 institutions (see Annex). These institutions are all domiciled in other EU jurisdictions and operate in Poland via a branch. In addition, as of that date, there were eleven institutions with an external credit rating qualifying them to be CQS 2 institutions. Of these, five are domestic institutions and six are EU institutions operating in Poland via a branch. The Polish Financial Supervisory Authority also clarifies that, due to the sovereign credit rating assigned to Poland, no credit institution operating may classify as a CQS1 on the basis of the sovereign rating.
9. According to the Polish Financial Supervisory Authority, among the six institutions classifying for a CQS 1 on the basis of the ECAI credit assessment, only one foreign branch (the branch of Skandinaviska Enskilda Banken AB SA) may provide services as counterparty in derivative transactions.
10. As of 30 June 2016, three covered bond issuers had outstanding covered bonds in Poland for a total nominal amount of approximately EUR 1.6 bn.
11. According to the Polish Financial Supervisory Authority none of these covered bond programmes assumed exposures to institutions to that date. Whereas covered bond issuers may fulfill the mitigation of currency risk required by the law (mostly EUR vs PLN) by entering into hedging derivative transactions, it appears that the outstanding covered bond programmes opted, where relevant, to mitigate currency risk by other means, including overcollateralisation in respective currencies (maintaining more assets in a cover pool in a given currency than covered bonds in respective currencies).
12. In the absence of a partial waiver, to achieve compliance with Article 129 of the CRR, covered bond programmes assuming exposures to institutions would, given the conditions verified as of 30 June 2016, potentially need to rely on only one institution. In addition, as the only eligible CQS1 name is the branch of an EU institution operating in Poland, Polish covered bond programmes would have to assume exposures to foreign institutions, which does not constitute a current market practice and would expose the covered bond programmes to further currency mismatches.
13. This also implies that the covered bond issuers within the jurisdiction may be more likely to breach the limits imposed by the CRR requirements on large exposures in relation to the names of the institutions eligible to act as counterparties.

⁵ Covered bonds and mortgage banks act of 29 August 1997, Article 19.

14. Taking into account:

- (a) the documented characteristics of the Polish banking and covered bonds markets;
- (b) the fact that, in accordance with Article 129 of the CRR, each issuing institution may collateralise with exposures to institutions up to 15% of its outstanding covered bonds;

the potential exposure of all Polish covered bond programmes to one eligible institution is in the view of the EBA likely to result in an excessive concentration towards one financial name and, consequently, to pose both prudential concerns and concerns related to the degree of competition in the Polish financial market.

Exercising the waiver

15. The EBA understands that the Polish Financial Supervisory Authority will issue an administrative decision to grant the waiver and will make such decision public.

Review of the waiver's continued relevance

16. The Polish Financial Supervisory Authority commits to monitoring the situation and evaluating the need for the continued use of the partial waiver at least annually, using information that documents the concentration problem. If the concentration problem is no longer significant, the partial waiver will be repealed.

17. In the event of a revocation of the waiver, a grandfathering period shall apply to exposures to CQS 2 institutions that would no longer be eligible to remain as collateral after the revocation of the waiver.

This opinion will be published on the EBA's website.

Done at London, 7 April 2017

[signed]

Andrea Enria

Chairperson
For the Board of Supervisors

Annex

List of institutions, as submitted by the Polish Financial Services Authority operating in Poland with an ECAI credit assessments equivalent to either CQS1 or CQS2, as of 30 June 2016

Institution	Moody's	S&P	Fitch
Svenska Handelsbanken AB SA (Polish branch)	Aa2	AA-	AA
Skandinaviska Enskilda Banken AB SA (Polish branch)	Aa3	A+	AA-
Elavon Financial Services Ltd. (Sp. z o.o.) (Polish branch)	Aa2	AA-	AA
Nordea Bank AB SA (Polish branch)	Aa3	AA-	AA-
Bank of China (Luxembourg) SA (Polish branch)	AA3	AA-	A+
Euroclear Bank SA/NV (Polish branch)	-	AA	A+
Bank Handlowy w Warszawie SA	A3		A-
Bank Polska Kasa Opieki SA	A2		A-
ING Bank Śląski SA	A3		A
Bank Zachodni WBK SA	A3		BBB+
Powszechna Kasa Oszczędności Bank Polski SA	A2		-
Pekao Bank Hipoteczny SA	-		A-
Societe Generale SA Oddział (Polish branch)	A2	A	A
BNP Paribas SA (Polish branch)	A1	A	A+
Danske Bank A/S Spółka Akcyjna (Polish branch)	A2	A	A
BNP Paribas (Polish branch)	A1	A	A+
UBS Limited (Sp. z o.o.) (Polish branch)	A1	A+	A+