Introduction and legal basis

The EBA competence to deliver an opinion is based on Article 29(1)(a) of Regulation (EU) No 1093/2010\(^1\), 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.

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On 17 December 2014, the German Federal Financial Supervisory Authority (Bundesanstalt für Finanzdienstleistungsaufsicht - BaFin) 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 Supervisors, the Board of Supervisors has adopted this opinion.

General comments

1. Having given consideration to the information provided by BaFin, with reference to the date of the notification (December 2014):

   (a) on the classification of German and Eurozone institutions in relation to the CQSs assigned on the basis of external credit ratings, whereby only two institutions were both eligible CQS 1 institutions and had a business model compatible with the nature of the exposures considered for the purposes of Article 129(1)(c) of the CRR;
   (b) on the composition of the German covered bond market and on the characteristics of the German covered bond regime at the time of the assessment;
   (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 Germany 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 a 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;

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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)).
(g) an assessment of the expected impact of granting versus not granting the partial waiver on Article 129(1)(c) of the CRR within the applicant jurisdiction;
(h) other general considerations, where appropriate.

3. The EBA considers several 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 account bank 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.

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 bondholder.\(^4\)

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\(^5\) 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.

\(^4\) 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

The concentration problem in Germany

7. Based on the information provided by BaFin, the EBA understands that covered bond programmes established in the jurisdiction’s covered bond regime may assume exposures to institutions mostly (although not exclusively), in the following circumstances:

(a) covered bonds issuers temporarily place funds with institutions due to mismatches in the timing of mortgage payment inflows and bond redemptions and to meet the requirement set out in the Pfandbriefgesetz (PfandBG) which requires coverage by liquid assets to meet obligations falling due within 180 days;
(b) covered bonds issuers enter into derivative contracts with institutions to hedge currency and interest rate risks;
(c) covered bonds issuers make use of instruments issued by institutions such as bonds, loans and term deposits, for risk management purposes and for covering rating agencies’ over-collateralisation requirements and statutory requirements for additional collateral. The PfandBG establishes a concentration limit on any single name of 2% of the nominal amount of outstanding covered bonds of the issuing institution.

8. Under the PfandBG two specific provisions apply in relation to derivatives:

(a) Derivatives can only be accounted for within the present value coverage requirement (minimum 102%) and are not considered for the purposes of computing and fulfilling the nominal coverage requirement.6
(b) Institutions acting as counterparties of covered bond issuers in a derivative contract must classify as CQS 1, unless – as introduced in December 2014 – such counterparties provide ‘adequate collateralisation’ of the position.

9. Consistently with (a) and (b), above, exposures to institutions in the form of derivatives are not included within the scope of the waiver implemented by BaFin7.

10. As documented by BaFin, as of March 2014, 12 German institutions had an external credit rating qualifying for CQS 1 (see Annex).

11. Of these, a significant number are specialist institutions with a limited business model which does not extend to a general activity involving taking inter-bank funds from covered bond issuers. More in particular:

- LfA Förderbank Bayern, Landwirtschaftliche Rentenbank, Kreditanstalt für Wiederaufbau, Sächsische Aufbaubank – Förderbank, Landeskreditbank Baden-Württemberg – Förderbank, NRW.BANK, Investitionsbank Schleswig-Holstein and Investitionsbank Berlin are promotional banks in nature and, based on information submitted by BaFin, legally hindered to offer general inter-bank business outside their promotional mandate;

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6 In its December 2016 ‘Report on Covered Bonds’ (see: https://www.eba.europa.eu/documents/10180/1699643/EBA+Report+on+Covered+Bonds+(EBA-Op-2016-23).pdf) the EBA advised that a harmonised EU framework on covered bonds should include a minimum nominal coverage requirement for the calculation of which the value of derivatives used for hedging purposes is taken into account. The EBA report also describes how such value should be calculated.
- Clearstream Banking Aktiengesellschaft operates in clearing services;
- KfW IPEX-Bank GmbH operates as a trade financier and export credit agency.

12. Of the two remainder CQS 1 German institutions, BaFin documented that HSBC Trinkaus & Burkhardt AG and St. Galler Kantonalbank Deutschland AG reported securities issued on a scale insufficient to meet investment reallocation needs of Pfandbrief bank cover assets.

13. To the best knowledge of BaFin\(^8\), as of March 2014, there existed 10 institutions being assigned an external credit rating that qualifies for a CQS 1 located outside of Germany, in a jurisdiction eligible under the PfandBG. Five of these institutions are based in jurisdictions outside the Euro area.

14. The availability of euro-denominated exposures to these institutions was assessed as limited and not appropriate for meeting the overall outstanding demand for exposures to institutions. In this respect, BaFin estimated that up to EUR 8.1 billion of exposures to institutions in the form of account banks and instruments were at stake as of March 2014.

15. Relying on eligible institutions located outside the euro area was assessed as inappropriate, as it would potentially expose German covered bond programmes to wide currency mismatches. In this respect BaFin documented that 96% of covered bonds issued by the members of the VDP\(^9\) were denominated in Euro at the time of the assessment.

16. Overall, to achieve compliance with Article 129 of the CRR in the absence of a partial waiver, covered bond programmes assuming exposures to institutions were assessed as potentially having to rely on only two eligible and business model-compatible German institutions.

17. 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.

18. Taking into account:

(a) the documented size of the German covered bond market;
(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 German covered bond issuers to only 2 available eligible institutions, documented with reference to the date of the notification (December 2014), is deemed to result in an excessive concentration towards individual financial names and, consequently, to pose both prudential concerns and concerns related to the degree of competition of the German financial market.

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\(^8\) BaFin documented the external credit ratings of 129 banks in 19 jurisdictions. The jurisdictions are those that are eligible under the PfandBG.

\(^9\) Association of German covered bonds issuers. Vdp-member banks represented a market share of Pfandbriefe in circulation of 98% at the time referenced in the data provided by BaFin.
Exercising the waiver

19. Based on BaFin’s submission, on 19 December 2014 a rule in Section 4 Paragraph 1 Sentences 4-8 of the PfandBG was introduced. This entitled BaFin to issue a general administrative order (Allgemeinverfügung) providing for the eligibility of deposits with and claims for the payment of monies against suitable domestic institutions with CQS 2 according to the external ratings-based method (CRR Article 120(1)(3)), on the basis that, otherwise, the restriction to CQS 1 exposures risked a material concentration with respect to domestic institutions. The general administrative order was issued on 22 December 2014 and came into effect on 1 January 2015, and was published on the BaFin website and in the Federal Gazette (Bundesanzeiger).

Review of the waiver’s continued relevance

20. Based on Section 4 Paragraph 1 Sentences 5-8 of the PfandBG setting out the ways and means of reviewing the partial waiver’s continued relevance:

(a) BaFin shall review, at least semi-annually, whether the grounds for the partial waiver continue to exist;
(b) the partial waiver shall be revoked as soon as the grounds for putting it into place no longer exist. The revocation of the waiver shall be published on the BaFin website and in the Federal Gazette;
(c) in the event of the revocation of the partial waiver, a grandfathering period of six months from the date of revocation shall apply for 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 BaFin, operating in Germany with an ECAI credit assessment equivalent to CQS1, as of March 2014

1. HSBC Trinkaus & Burkhardt AG;
2. LfA Förderbank Bayern;
3. Landwirtschaftliche Rentenbank;
4. Clearstream Banking Aktiengesellschaft;
5. Kreditanstalt für Wiederaufbau;
6. Sächsische Aufbaubank – Förderbank;
7. Landeskreditbank Baden-Württemberg – Förderbank;
8. NRW.BANK;
9. Investitionsbank Schleswig-Holstein;
10. Investitionsbank Berlin;
11. KfW IPEX-Bank GmbH;
12. St.Galler Kantonalbank Deutschland AG.