ECBC Response to the European Supervisory Authorities

Second Consultation Paper on Draft Regulatory Technical Standards on Risk-Mitigation Techniques for OTC-Derivative Contracts not Cleared by a CCP under Article 11(15) of Regulation (EU) No 648/2012

Brussels, July 2015

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 launched by the European Mortgage Federation (EMF) to promote the interests of covered bond market participants at international level. As of July 2015, the ECBC brings together over 100 members from more than 25 active covered bond jurisdictions representing over 95% of the EUR 2.6 trillion outstanding covered bonds.

The ECBC welcomes the opportunity to provide the European Supervisory Authorities (ESAs) with its feedback on the Second Consultation Paper (JC/CP/2015/002) with regard to the draft regulatory technical standards (RTSs) in terms of the European Markets Infrastructure Regulation (EMIR)[2] which was launched on 10 June 2015. The ECBC would also like to thank the ESAs for their ongoing commitment to a constructive dialogue.

General Comments

As a matter of background information, 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 and/or public-sector debt. For over 200 years, covered bonds have proved to be an efficient debt instrument enabling banks to mobilise private sector means and capital towards long-term investment with a wide public benefit and, in particular, housing loans and public sector debt. They have also been, during the recent financial turmoil, one of the only asset classes able to restore investor confidence and to ensure access to debt capital markets for European issuers.

The ECBC is strongly supportive of the goal of improving the resilience, transparency and efficiency of the OTC derivatives market. It therefore welcomes the efforts of the European Institutions to take into account the specificities of covered bonds. In Recitals 16 and 24 of EMIR, European regulators have indeed considered that two specificities should be taken into consideration when establishing the draft technical implementation measures:

- The specific provisions of covered bonds' legal frameworks that would make OTC derivatives, which are used to hedge interest rate and/or currency risk within covered bond programmes (referred to herein as "covered bond derivatives"), ineligible for clearing through a Central Clearing Counterparty (due to, among other reasons, the fact that the derivative is designed to survive the insolvency of the issuing institution, whereas the standardised documentation requires that all derivatives be closed out at the time of an issuer's insolvency).

- The fact that in many jurisdictions collateral posting is unilateral (as dictated by covered bond legal frameworks and rating agency criteria) - i.e. the issuer does not post collateral, whereas the counterparty does, when required.

[1] The European Mortgage Federation - European Covered Bond Council (EMF-ECBC) is registered in the European Institutions' Transparency Register under ID Number 24967486965-09.

[2] Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC Derivatives, Counter Counterparties and Trade Repositories.

Further to this, the ECBC particularly welcomes the fact that the ESAs have acknowledged the special features of covered bond-related derivatives and allowed for such derivatives to be excluded from bilateral collateral posting of initial and variation margins, while ensuring the derivative counterparties a degree of protection by outlining specific conditions that have to be met.

Moreover, we consider that the latest draft of the Commission Delegated Regulation, as proposed in the ESAs Second Consultation Paper (JC/CP/2015/002) presents a lot of improvements compared to the previous version outlined in the First Consultation Paper (JC/CP/2014/03). In particular, we appreciate the fact that the requirement in Article 8 (2)(a) GEN[3] - Treatment of derivatives associated to covered bonds for hedging purposes - has been amended and now specifies that the OTC derivative contract is not terminated in case of resolution or insolvency of the covered bond issuer or cover pool. This amendment aligns with the feedback that the ECBC provided in its official response from 14 July 2014, where we commented on the reference to the case of default of the covered bond issuer and proposed to narrow the scope of the article to 'insolvency related' defaults. Essentially, our comments outlined that the purpose of this restriction should be to avoid that the derivative is terminated as a result of the issuer's insolvency, not to prevent the counterparty from terminating upon other non-insolvency-related defaults.

Following on from this, we would like to share our observations in respect to the next subparagraph of the same article, i.e. Article 8(2)(b) GEN whose wording is unclear to a certain extent, in our opinion. In view of this, we would like to propose an amendment to this provision, reading as follows:

"[…] (b) The counterparty to the OTC derivative contract ranks at least pari passu with the covered bond holders, except *that a more junior ranking is permitted* where the counterparty to the OTC derivative concluded with covered bond issuers or with cover pools for covered bonds is the defaulting or the affected party".

Our proposal for the aforementioned amendment stems from the fact that the draft legislative clause, in the form currently proposed in the Second Consultation Paper (JC/CP/2015/002), could be interpreted as implying that derivatives need to have switch or flip clauses. Contrary to that assumption, we believe that the intention of the paragraph should be to provide a *possibility* to use this type of clauses.

Moreover, it should be confirmed or clarified, for avoidance of doubt, that references made to "the defaulting party or the affected party" are compliant with and covered by all the provisions or definitions under the master documentation provided for by the International Swaps and Derivatives Association (ISDA) and any other professional banking associations (such as the French Banking Federation master agreement relating to transactions on forward financial instruments or the German Master Agreement for Financial Derivatives Transactions as updated from time to time, for example). Such confirmation should be brought by a specification included either in the EMIR level 2 provisions or at least within the Questions & Answers document as regularly updated by ESMA on EMIR. Such clarification would ensure the efficiency of the provisions proposed by the ESAs.

In addition, we would like to suggest the removal of the requirement for covered bond issuers/cover pools to collect variation margin (VM) and for counterparties of third-country covered bond issuers to post VM. This proposal is in view of the need for a flexible approach with the possibility to have rather high thresholds and/or rating triggers for when VM needs to be collected. Based on feedback received, in many jurisdictions covered bonds issuers are not currently collecting VM in practice, although in theory the collateral arrangements are in place. The current approved standard for covered bonds linked collateral agreements provides for high thresholds and downgrading triggers which in some cases give rise to the transfers of collateral. A new structure which would require collecting VM without thresholds may have a negative effect on the covered bond activity in general. The covered bonds issuers would

[3] Previously Article 3(1)(a) GEN, as outlined in the ESAs First Consultation Paper (JC/CP/2014/03).

have to build an infrastructure to allow collecting and maintaining the variation margin in a way compliant with the regulations, including the eligibility criteria monitoring, etc. This will result in a significant increase of the cost of hedging covered bonds and the number of possible counterparties may be reduced if they are required to post VM without any thresholds or rating triggers.

Following on from this, and in line with the EMIR objectives, the margining rules should address the systemic risks in the flow OTC derivatives market where a regulatory framework has not already provided for satisfactory safety net from the risk management perspective. In parallel, the new requirements should preserve the existing well-functioning structures with clear benefit for the financial markets and the economy as a whole. Further, it should in this context also be noted that the industry standard and the rating agencies requirements in general also include a replacement trigger which means that the counterparty needs to replace itself upon the occurrence of certain rating events. This gives the covered bonds issuers protection if the credit rating of the counterparties should decrease.

Last but not least, we would like to highlight our support of the idea of using an EU-harmonised classification of covered bonds as it ensures adequate and equal privileges for this class of financial instruments.

Indeed, the success of covered bonds in Europe lies in the Industry's capacity to respond to the challenges of the current crisis, its ability to share best market practices - thereby allowing the continuous fine-tuning of European covered bond legislation, helping to significantly increase the transparency and contributing to a principle-based harmonisation of the asset class. An example of this is the launch, in January 2013, of the Covered Bond Label initiative which, in line with the European Commission's and the European Central Bank's calls for further harmonisation, aims at responding to the request for improved standards and increased transparency at European level. The Covered Bond Label facilitates access to relevant and comprehensive information at bond, pool, issuer and legal framework levels and facilitates comparisons at jurisdiction level through transparency disclosures and common definitions.

Since 1 January 2014, the Covered Bond Label Convention, which defines the core characteristics required for a covered bond programme to qualify for the Label, was amended to require compliance with Article 129 of the Capital Requirements Regulation (CRR – Regulation (EU) No 575/2013). In view of this, the fact that Article 8(2)(f) GEN refers to this same regulation indeed is in line with the changes undertaken by the covered bond Industry through this market initiative.