

## ECBC Response to ESMA

### Consultation Paper on the Clearing Obligation under EMIR (no. 4)

Brussels, 14 July 2015

The European Covered Bond Council (ECBC)<sup>1</sup> 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 feedback to the European Securities and Markets Authority (ESMA) as a response to the ESMA's Consultation Paper on the Clearing Obligation (no. 4) under the European Markets Infrastructure Regulation (EMIR)<sup>2</sup> which was launched on 11 May 2015. The ECBC would also like to thank ESMA for their ongoing commitment to a constructive dialogue.

#### General Comments

By way of background, 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 supportive of the goal of improving the resilience, transparency and efficiency of the OTC derivatives market and, in particular, welcomes the efforts of the European Institutions to take into account the specificities of covered bonds. In Recitals 16 and 24, 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 (CCP), 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.

Covered bond legislation is specifically designed to protect the market against financial turmoil. Therefore, we welcome the fact that the ESMA has acknowledged the special features of covered bond-related derivatives and allowed for such derivatives to be excluded from the clearing obligation by outlining specific conditions that have to be met. We consider the exclusion of this relief to be essential to the proper functioning of the covered bond derivatives and covered bond programmes in general.

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

<sup>2</sup> 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.

To recall, EMIR introduces the obligation to clear certain classes of OTC derivatives in central counterparty clearing houses (CCPs) that have been authorised (for European CCPs) or recognised (for third-country CCPs) under the EMIR framework and provides ESMA with the responsibility and the tools to propose which classes should be subject to the clearing obligation.

In view of this legislation, we consider that the latest draft of the Commission Delegated Regulation, as proposed in the ESMA's Consultation Paper (no. 4) presents a lot of improvements compared to the version outlined in the ESMA's Consultation Paper (no. 1) from 11 July 2014. In particular, with regard to Article 1(2)(c) – Classes of OTC derivatives subject to the clearing obligation – we appreciate the fact that the outlined requirement has been expanded, as proposed by the ECBC's response from 14 August 2014, and now includes the options of “resolution or insolvency of the covered bond issuer” whereas in the previous version of the draft provision, only the instance of default of the covered bond issuer was mentioned.

Following on from this, and in terms of the ranking as regards to the counterparty default, covered bonds' legal documentation often foresees, requested by the rating agencies, a “flip clause” which triggers the loss of the senior rank in the priority order when the derivative counterparty is in default. Therefore, in the ECBC's response to the ESMA's Consultation Paper (no. 1) we outlined that the flip clause may be an impediment to fulfil the condition set up in the draft legal provision when “the counterparty [...] ranks at least *pari-passu* with the covered bonds holders”, previously included as Article 1(2)(b). Therefore, we are appreciative of the fact that our feedback has been taken into account and the wording of Article 1(2)(d) now includes a reference to “the defaulting or the affected party”, thus taking into account the flip clause. However, the draft legislative clause, as currently drafted, 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. In view of this, we would like to propose the following amendment to Article 1(2)(d) in italics:

“[...] (d) the counterparty to the OTC derivative concluded with covered bond issuers or with covered pools for covered bonds ranks at least *pari-passu* with the covered bond holders except where the counterparty to the OTC derivative concluded with covered bond issuers or with covered pools for covered bonds is the defaulting or the affected party *where a more junior ranking is permitted, or if the counterparty waives the pari-passu rank.*”

Also, the ECBC notes that the current consultation paper builds on the previous ESMA's consultative documents on the clearing obligation and in particular, provides explanations on the draft regulatory technical standards (RTS) that establish a clearing obligation on additional classes of OTC interest rate derivatives that were not included within the scope of the ESMA's Consultation Paper (no. 1) on the clearing obligation for interest rate swaps from 11 July 2014. In particular, the additional classes added to the scope of the consultative document include fixed-to-float interest rate swaps (IRS) denominated in certain non-G4 currencies, i.e. CZK, DKK, HUF, NOK, SEK and PLN, together with forward rate agreements denominated in NOK, SEK and PLN.

Last but not least, the ECBC supports 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 1(2)(e) refers to this same regulation indeed is in line with the changes undertaken by the covered bond Industry through this market initiative.