

23rd of July 2015

EMF-ECBC Position Paper on the Net Stable Funding Ratio (NSFR)

General remarks

1. The EMF-ECBC¹ would like to recall the European Commission's statement in its 2014 Communication on Long-Term Financing of the European Economy: *"The Commission will take the fullest account, in the preparation of [...] the final calibration of the NSFR, of the need not to unduly restrict long-term financing by banks."*² The EMF-ECBC would like to underline that covered bonds are at the heart of the financial tradition of Europe, playing an important role in funding strategies for the last two centuries and proving to be a cost-effective and reliable long-term funding debt instrument, characterised by key safety features, including a strict legal and supervisory framework, asset segregation and an actively managed cover pool. They played a pivotal role in bank wholesale funding during the recent financial turmoil as one of the only asset classes able to restore investor confidence and ensure access to debt capital markets for European issuers. The EMF-ECBC is very concerned that the current NSFR proposals from the Basel Committee on Banking Supervision (BCBS) would unduly restrict the covered bond market and therefore unduly restrict long-term financing.
2. In fact, the current wording of the NSFR displays a two-tiered bias. On one level, the NSFR favours deposits over capital market funding. The BCBS considers deposits as a more stable source of funding, thus it assigned them more favourable factors. The EMF-ECBC believes that this preference is debatable from a theoretical standpoint and that it might foster a practical overreliance on deposits. On a subsequent level, the NSFR favours unsecured over secured debt within the capital market-based funding instruments. The reason is twofold: (1) on the assets side, by focusing only on maturity, the NSFR fails to acknowledge the heightened security offered by the cover pool and (2) on the liabilities side, it makes the issuance of secured debt relatively more expensive, in terms of NSFR ratios, due to the encumbrance "discount" assigned to the mortgages in the cover pool.

Treatment of covered bonds for investors

3. Overall, the EMF-ECBC finds that unencumbered covered bonds are generally highly liquid instruments and should therefore qualify for very low Required Stable Funding (RSF) factors.

¹ Established in 1967, the European Mortgage Federation (EMF) is the voice of the European mortgage industry, representing the interests of mortgage lenders and covered bond issuers at European level. The EMF provides data and information on European mortgage markets, which were worth over €6.7 trillion at the end of 2013. As of February 2015, the EMF has 18 members across 14 EU Member States as well as a number of observer members. In 2004, the EMF founded the European Covered Bond Council (ECBC), which is a platform that brings together covered bond market participants. The EMF-ECBC is registered in the EU Transparency Register under ID Number 24967486965-09.

² Communication from the Commission to the European Parliament and the Council on Long-Term Financing of the European Economy (COM/2014/0168 final), available at <http://goo.gl/OMTjCQ>.

4. The EMF-ECBC is strongly supportive of the fact that, due to the unique characteristics of the EU covered bond market, and in line with the decision taken by the European Commission in its Delegated Act on the Liquidity Coverage Requirement³ (LCR, published on 10/10/2014), extremely high quality covered bonds should be treated as Level 1 assets, and thus fall under the 5% RSF category of the NSFR.⁴
5. Similarly, high quality covered bonds that do not qualify for Level 1 treatment should, if they qualify for Credit Quality Step 2, be treated as Level 2A assets, and thereby qualify for the 15% RSF category.
6. Remaining covered bonds that do not qualify for Level 1 or Level 2A should be treated as Level 2B assets and assigned an RSF of 50%.
7. The EMF-ECBC endorses the fact that the Net Stable Funding Framework rightfully acknowledges that the appropriate stable funding requirements of a covered bond mainly relies on the credit quality.
8. Therefore, we do not support that fact that covered bonds backed by cover pools with high credit quality would be treated differently in the NSFR because of differences in issue size as is the case for the LCR Delegated Act. In the Delegated Act, both rating and issue size define the - short-term - liquidity of an asset.
9. By not relying on issue sizes with respect to RSF treatment, it is ensured that covered bonds - issued from the same prime cover pools - fulfil the same stable funding requirements.

Interdependent cover assets and covered bonds

10. In order to appropriately address the specificities of covered bond funding and the reliability of this instrument, the EMF-ECBC supports the option for national supervisors to identify assets and liabilities which are interdependent and set the RSF and the ASF to zero for such assets and liabilities. The EMF-ECBC finds that cover assets and covered bonds should be deemed to be interdependent assets and liabilities if:
 - a. Issuers are required by law to segregate cover assets and covered bonds from other assets and liabilities, i.e. the assets and liabilities are clearly identifiable.
 - b. Covered bonds are secured by a first claim on the cover assets. In a bankruptcy scenario payments on cover assets may only be used for the payment of interest and principal on covered bonds, i.e. the principal payment flows from the asset cannot be used for anything else than repaying the liability.

³ http://ec.europa.eu/finance/bank/regcapital/acts/delegated/index_en.htm.

⁴ The NSFR is calculated as the ratio of Available Stable Funding (ASF) and Required Stable Funding (RSF), which has to always be greater than 100%. See Table 2 on page 11 of "[Basel III: The Net Stable Funding Ratio](#)", Basel Committee on Banking Supervision, October 2014.

- c. In some jurisdictions, payment imbalances on cover assets and covered bonds are capped by law (matching principle). Payments from cover assets therefore balance payments of interest and principal on covered bonds, i.e. principal amounts of assets and liabilities are the same.
11. Section 45 (interdependent asset and liabilities) of the NSFR proposal from the BCBS should be amended in such a way that cover assets and covered bonds with the characteristics outlined above should fall under its scope, thereby giving national supervisors discretion to set the RSF and the ASF to zero for cover assets and covered bonds, respectively.
12. In some jurisdictions, the interdependency of cover assets and covered bonds is further supported by:
- a. The application of a pass-through principle effectively eliminating payment imbalances on cover assets and covered bonds, i.e. the bank is acting solely as a pass-through unit.
 - b. Options to extend the term-to-maturity of covered bonds to (ultimately) match the maturity of the cover assets in a scenario where the refinancing of maturing covered bonds fails, i.e. the maturity of assets and liabilities are the same. Such options may either be enabled contractually or by regulation.

Treatment of assets encumbered by covered bond issuance

13. With regards to asset encumbrance arising from the issuance of covered bonds, it is important to highlight that this product is typically backed by a pool of mortgages (and/or public sector loans)⁵. On top of this, covered bond pools are subject to over-collateralisation requirements. Generally speaking, RSF weightings on identical assets on the balance sheet should not depend on how the assets are funded. Therefore, mortgages in the cover pool should not be given a less favourable treatment due to the fact that they have been funded via covered bonds. Generally, cover assets in covered bond cover pools should be treated as unencumbered as they are able to generate liquidity to pay covered bond holders.
14. In case the regulator deems an encumbrance “discount” necessary, the cover pool encumbrance should always be treated from a portfolio perspective, so as to deliver a more realistic picture of the risk profile of covered bond funding. The EMF-ECBC believes that the dynamic nature of the cover pool, i.e. the continuous inflows and outflows of mortgages, calls for a factor for each maturity bucket rather than for each underlying mortgage. More specifically, the encumbrance amount could be adjusted on each time bucket.
15. The default of an issuer does not accelerate its covered bond liabilities and therefore does not necessitate an immediate sale of cover pool assets. There is no acceleration of payment obligations. The cash flows deriving from underlying assets continue to repay the obligations in accordance with the contractual schedules to the extent possible. Therefore, assigning a non-favourable weight to assets funded by covered bonds, on the grounds of their lesser liquidity, ignores the specifics of the

⁵ For the sake of simplicity, public sector loans will not be included in the rest of this paper.

covered bonds framework. Moreover, in a number of jurisdictions covered bond issuers are subject to specific asset liability management and liquidity risk rules which limit maturity transformation of positions. In a recent publication⁶, the European Banking Authority (EBA) encourages the different legislative bodies to take account of these rules in their regulatory framework. As a consequence, the NSFR aims at limiting the maturity transformation. Thus, it should have a very limited impact on covered bonds.

16. Regardless of the type of approach to the cover pool, the EMF-ECBC believes that whatever the value of the overcollateralisation of the pool, at least this amount can be treated as unencumbered. This is because the value of the overcollateralisation is, by definition, in excess of the corresponding value of the issued covered bonds. As such, mortgages that are used for the overcollateralisation of the pool (be it minimum legal, contractual, actual, voluntary, etc.) should be treated as unencumbered. In this respect, the value of the mortgage loans (or a part of said loans) that is to be treated as encumbered should equal the face value of the total outstanding covered bonds issued by the institution. In any case, the value of encumbered mortgage loans should never exceed the value of covered bonds outstanding.
17. Considering the assets of the cover pool as unencumbered would curb the disparity of treatment between secured and unsecured debt. In fact in the BCBS's reform proposal framework, an identical mortgage would receive a better weighting, if backed by unsecured debt than if backed by a covered bond. This goes against the principle of a level playing field and is detrimental for covered bond issuers, especially specialised ones.

Treatment of covered bonds with residual maturity below 1 year and overreliance on deposits

18. The issuance of covered bonds is penalised under the NSFR when the residual maturity of the covered bond falls under 1 year.

Residual Maturity of Covered Bond	ASF weight for Covered Bonds	RSF weight for underlying mortgage loans in pool
≥ 1 year	100%	100% (encumbered)
< 1 year and ≥ 6 months	50%	65% (unencumbered)
< 6 months	0%	65% (unencumbered)

We can assume, as in the table above, a 65% RSF, rather than the less favourable 85%, given that in every country in the EU (at least in the 22 largest covered bond markets), the highest possible value of the mortgage loan that can be used as collateral in the pool is 80% LTV. Anything in excess cannot count towards the core value of the cover pool. This is effectively in line with a 35% risk weighting according to the standardised approach, making the mortgages in the pool eligible for a 65% RSF weight. 100% RSF is the current level of weighting in the BCBS proposal even though a favourable treatment in the specific case of cover pool assets would be warranted.

⁶ Opinion of the EBA on the preferential capital treatment of covered bonds ([EBA/Op/2014/04](https://www.eba.europa.eu/media/1000000/2014/04/eba_op_2014_04.pdf))

19. It is therefore evident that two cliff effects are created: one at the 1 year point, and the other at the 6 months point. This would mean that institutions relying on covered bonds for the funding of mortgage lending might face a stable funding deficit in these periods. This is particularly problematic for institutions that do not (or are not allowed to) collect deposits, upon which the NSFR, as defined by the BCBS, is excessively reliant.
20. Linked to this point, the NSFR in its current form does not distinguish between secured and unsecured wholesale funding, as all short term capital market funding is treated as unstable funding. As became apparent during the financial crisis, however, covered bonds proved to be more stable than unsecured wholesale funding.
21. Moreover, it is not clear how funding instruments entailing an issuer's option to extend maturity will be treated. Generally, funding instruments should be treated as long term stable funding if the effective maturity is more than 1 year in all scenarios or conditional on specific market conditions where the instruments cannot be refinanced (not at issuers discretion). For example, instruments with embedded conditional options to delay the maturity date in case the issuer is unable to refinance them should be considered long term stable funding. Such instruments include bonds with soft bullets, with conditional pass through or with a regulatory trigger for maturity extension - in particular instruments where the extension ultimately can be matched with the maturity of the underlying assets. From an investor's perspective, however, positions in instruments with a conditional maturity extension option should not give rise to a higher level of required stable funding. This is because there is only a chance of the maturity being extended, rather than a certainty. So unless the new RSF factors also reflect the probability of the maturity extension the RSF should not change for the investor.
22. Furthermore, from an investor perspective, it is important to note that the issuer typically does not have the option to extend the maturity, unless it is in default. Therefore, given the lack of issuer optionality when it comes to maturity extension, this feature should not be considered in the NSFR because the ratio is meant to regulate stable long term funding levels for a well-functioning entity. It is not the NSFR's purpose to gauge what occurs in case the entity defaults.
23. In addition, covered bonds cannot be generally drawn by the investors on a daily basis. Accordingly, covered bonds secured by high quality assets and meeting jurisdiction-specific regulatory requirements should be treated as stable funding in accordance with their higher refinancing probability compared to unsecured funding. Thus, Available Stable Funding (ASF) factors of covered bonds appear very low, particularly when compared to ASF factors on stable and less stable deposits and/or term deposits with residual maturities of less than one year provided by retail and SME customers (respectively 95% and 90% ASF). Therefore, ASF factors for covered bonds should be adjusted upwards to better reflect the true funding behaviour of covered bonds. If it is to remain in its current form, the NSFR is poised to trigger an unnecessary overreliance on deposits, which can be drawn at any time and have not demonstrated a greater degree of stability than secured debt.

The treatment of swap agreements on covered bonds

24. In the existing framework defined by the EBA, an institution with both net derivatives liabilities (i.e. payable) and assets (i.e. receivables) on its balance sheet shall calculate the NSFR positions according to regulatory netting rules. A number of institutions have entered derivative contracts for the purpose of managing their covered pools, entailing asymmetric collateral agreements. In many jurisdictions, in this contractual framework the covered bond issuer does not post any collateral to hedge the credit risk supported by the banking counterparty, whereas the counterparty does, when required. This is possible because the derivative product benefits from the same claim on the cover pool as the covered bond. Indeed, cover pools are constructed so that no stakeholder obtains a preferential treatment in priority to covered bondholders. Nevertheless, the counterparties have a *pari passu* claim on the assets in the cover pool.
25. The weighting of these non-collateralised assets at 100% RSF is hardly justifiable, as it does not take into account the secured nature of the asset. Incidentally, the secured profile of these products has been recognised in other regulatory statements e.g. the EMIR RTS proposal. Thus, the protection offered by the cover pool (*pari passu* claim) and the absence of swaps termination (as they are designed to survive the insolvency of the issuing institution) should be considered as cash-like collateral, and be treated accordingly in the calculation of the NSFR, i.e. with a 0% RSF weighting. In the same way, the 20% RSF weighting for derivatives the mark-to-market value of which is negative should equally have a 0% RSF weighting due to the fact that the issuer does not post any collateral and thus, there is no need to finance it. These amendments are vital to ensure the continued ability of covered bond issuers to close new swaps with their banking counterparts. This is due to the possible funding needs for the over 1 year bucket which can occur in case of adverse evolution of the mark-to-market.

Other remarks

26. With the reduction in detail of time to maturity of some of the RSF factors in the January 2014 revisions to the Basel III NSFR framework, which means that all unencumbered securities are assigned an RSF factor without taking into account the time to maturity, all level 1 government bonds now are assigned a 5% RSF until maturity. This is inconsistent with the LCR, which does not impose any limitations on government bonds.
27. The current design of the NSFR, albeit rightly fostering long term funding, may have a negative impact on the price and volatility of good short term instruments. Financial institutions with a low NSFR might, in fact, quickly shift to other funding methods which enhance the ratio.
28. In the case of retail banking, the negative impact of the NSFR could occur in two ways:
- a. A reduction in the lending capacity to the economy (households and enterprises) as a consequence of the need to maintain liquid assets.
 - b. An increase in the size of balance sheets that makes it difficult to manage liquidity and leverage ratios.