

28th June 2016

EMF-ECBC response to the DG FISMA's Consultation Paper on Further Considerations for the Implementation of the NSFR in the EU

The EMF-ECBC welcomes the opportunity to respond to this targeted consultation and the constructive approach undertaken by the European Commission. As already recognised in the LCR implementation the Covered bond industry plays a fundamental role in providing long-term, stable financing to the real economy and investors' confidence especially in market turmoil.

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.

As demonstrated during the past years of crisis, equipping European lenders with CB programmes gives access to a cost efficient and reliable financing channel. This asset class enhances asset liability management, making the maturity transformation capabilities of the entire banking sector more robust. During the crisis, this funding tool proved to be reliable source of liquidity, preventing a fire sale of assets. In this way the covered bond product contributed to reinforcing the performance of mortgage markets. The due diligence and market best practices of covered bond issuers and investors have converged significantly at European level and have provided a robust common set of long term funding strategies to European Stakeholders. In response to the targeted Consultation, we would like to share with the European Commission a series of considerations with a view to contributing to the proper calibration of the NSFR and preventing unintended consequences which could seriously jeopardise the smooth functioning of the covered bond market by penalising secured funding vis-à-vis unsecured funding.

Against this background, we welcome 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."*¹

Potential adjustments resulting from complying with the NSFR

1. *In light of previous consultations, could you describe more specifically, if appropriate, the specific activities, transactions and business models where you have evidence that the implementation of the NSFR could have an excessive impact or important unintended consequences?*

- *Proportionality and level-playing field issues*

The NSFR in its current calibration poses a grave proportionality and level playing field issue for those specialised lenders whose business model is based on the issuance of covered bonds. It is worth mentioning that these business models have proven to be very resilient and as such are of relative low concern for financial stability. Covered bond issuing institutions are discriminated against vis-à-vis non-covered bond banks in relation to RSF and ASF factors.

¹ 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 ([link](#)).

We recognise the fact that the RSF is calibrated in order to reflect the different degrees of liquidity, i.e. the required stable funding, of the different asset classes. As such mortgages are seen as more liquid than other long term loans. This fact is reflected in the 65% RSF. However, if encumbered, the RSF for mortgage assets is increased to 100%. Covered bond issuing institutions have a business model that is heavily penalised by this NSFR requirement and yet using mortgage loans as collateral for covered bonds does not have the same effects as other types of collateralisation.

If the covered bond issuing institutions, at a maturity date, would not be able to refinance the amount due with a new covered bond, all the assets that have been pledged would suddenly be unencumbered, and receive a new and lower RSF. If, for example, the amount due were to be refinanced by a senior unsecured bond with a maturity of more than one year, the NSFR would look much better compared to the refinancing by a long term covered bond. This does not reflect the real refinancing risk in an appropriate manner and would raise the refinancing and liquidity risks for these business models. The fact that secured and unsecured lending is treated differently for RSF purposes provides wrong incentives for institutions to replace covered bond funding with shorter term senior bonds.

The following scenario illustrates this issue:

- The outstanding volume of the covered bond is 100
- The value of the encumbered assets is 100
- For the sake of simplicity, we do not include any over-collateralisation
- The due date of the bond is 1 year at the date T0
- The dates T1, T2 and T3 are 6, 9 and 12 months after T0 and T4 is the refinancing date
- At T3 the bond is due and refinanced by a senior bond

The NSFR would then show this pattern:

	T0	T1	T2	T3	T4
		6 months	9 months	12 months	
ASF	100	50	0	0	100
RSF	100	65	65	65	65
NSFR	100 %	77 %	0 %	0 %	154 %

If, instead, the amount due is refinanced by a covered bond at T4, the NSFR would develop as such:

	T0	T1	T2	T3	T4
		6 months	9 months	12 months	
ASF	100	50	0	0	100
RSF	100	65	65	65	100
NSFR	100 %	77 %	0 %	0 %	100 %

Mortgages in the cover pool, as a general rule, should not be treated differently if financed by covered bonds or senior unsecured debt. Distinguishing between encumbered or unencumbered assets in a covered bond vehicle makes no sense as they are all used (with over-collateralisation) to ensure that the issuer is able to fulfil the payment obligations to its covered bondholders. There is a risk that the proposed NSFR rules are detrimental to a functioning market, and a reliable, low-risk funding, low-risk business model in a number of jurisdictions where covered bond funding has provided a stable funding source over decades.

On the ASF side, however, secured lending and unsecured lending are treated in the same way. Here, maturing covered bonds follow the same treatment as unsecured securities. Maturing covered bonds do not receive a preferential treatment for ASF purposes counterbalancing the RSF disadvantages, although covered bonds have proved to be a reliable funding tool for mortgage assets. Additionally, as became apparent during the financial crisis, secured wholesale funding instruments including covered bonds are more stable than unsecured wholesale funding.

- *Over-collateralisation & Asset Encumbrance*

The implementation of the NSFR, with the calibration proposed by the Basel Committee, penalises covered bond issuing institutions because of the treatment of the covered bonds' over-collateralisation (OC). We recognise that this is a very sensitive issue and it is important to stress that the dynamic nature of the cover pool and over-collateralisation have been identified as key characteristics of this asset class, regulated by strict legal and contractual requirements. These characteristics have ensured investor confidence and appetite. OC can either be committed (legally and/or contractually), or provided voluntary, in order to enhance the credit standing of the issuance. Importantly, legal frameworks and rating agencies require different OC levels.

In recent years, the covered bond community has made immense efforts to enhance the general level of transparency on the asset collateral level, triggering investor due diligence and reducing overreliance on external ratings. This includes the introduction of new transparency frameworks, such as the Covered Bond Label ([link](#)) and its Harmonised Transparency Template ([link](#)), a change in the investor behaviour and the increased importance of external ratings. In the context of the harmonisation of market best practices in the covered bond space, the Industry has identified the ongoing obligation of the credit institution to maintain sufficient assets in the cover pool to satisfy the claims of covered bondholders at all times as a fundamental qualitative component. This is a key requirement of the Covered Bond Label Convention ([link](#)).

This said, in the current NSFR calibration, all assets included in the cover pool are treated as encumbered, in a liquidity sense. As they are considered encumbered, all cover assets (including OC) get a 100% RSF weight. Thus, each covered bond issuance results in a further "NSFR burden". Different nuances can be considered in term of encumbrance. Looking at committed OC, it is important to stress the particularity of the dynamic nature of the cover pool, which means that it is not the single collateral asset, the mortgage, which is directly encumbered but the collateral cover pool magnitude. Single assets can be removed individually under the strict rules and requirements foreseen in the national covered bond legislation and in contractual agreements.

In order to understand why this approach can be misguided in the case of covered bonds we have to look at how the Cover Asset Monitor (CAM), i.e. the cover pool manager, manages the dynamic cover pool. Before withdrawing an asset from the cover pool the CAM performs a number of checks. Once the checks are completed, the assets can be removed from the cover pool. The CAM does not necessarily take into account rating agency over-collateralisation requirements (unless contractually/legally committed as part of an issuance) in conducting these checks and has no reason not to approve asset removal once these tests are passed.

As such, voluntary OC, which goes beyond the committed OC, is available to the CAM, and is not legally or contractually encumbered. Naturally, as the European Commission is aware, there also market factors, such as the risk of a downgrade, which might influence the decision of the CAM to cut OC. Nevertheless, as we have pointed out, since the crisis the reliance on rating agencies has been substantially reduced. Transparency efforts from the Industry have significantly enhanced investors due diligence capabilities. These are all reasons why the EMF-ECBC is of the view that voluntary OC assets (i.e. not legally required or contractually committed) should be treated as unencumbered and receive a lower RSF factor.

Assets held for credit enhancement purposes in a cover pool (regulatory or rating requirements) should not be mistaken as in general encumbered assets in a liquidity framework. The purpose of those assets is exactly to be used to generate liquidity either through outright sale or, for instance, through repo transactions when needed. This view is further underlined due to the fact that rating agencies and CRD IV/CRR both acknowledge assets held for rating requirements and capital requirements in cover pools as assets available for liquidation (which is also in line with the fact that neither rating agencies nor CRD IV/CRR/LCR differentiates with respect to the funding of the OC).

Moreover, the encumbrance nature of OC from a liquidity perspective has been already addressed in the LCR implementation. The LCR Delegated Act includes a definition of unencumbered assets as part of the liquidity definition. In order to ensure consistency in the liquidity regulation, it seems appropriate to replicate the definition of unencumbered assets in the NSFR or simply to make a reference to the LCR Delegated Act. Assets that are classified as unencumbered under the LCR should also be classified as unencumbered under the NSFR.

Perversely, the NSFR also potentially creates an incentive to actually reduce the OC in the cover pool to an absolute minimum, implying reduced protection for the bondholders, as a result of the 100% RSF, whereas the RSF factor will be lower if assets are placed outside of the cover pool.

▪ *Interdependence of assets & liabilities*

With the applicable ASF and RSF factors in the Basel NSFR, pass-through financing models — with a balance sheet structure of mainly bonds and cover assets (mortgage lending) deemed as encumbered assets — will obtain an NSFR level of maximum (and often below) 100%. Significantly, this concern is highlighted by the EBA on page 140 of its recently published Report on the NSFR.

In order to appropriately address the specificities of covered bond funding and the reliability of this instrument, we support 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. Cover assets, covered bonds and associated derivatives should be deemed to be interdependent assets and liabilities if:

- 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.
- Covered bonds are secured by a first claim on the cover assets. In a bankruptcy scenario payments on cover assets must primarily 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 before the repayment of the liability.
- In some jurisdictions, payment imbalances on cover assets and covered bonds are capped by law (matching principle), for instance by way of a maximum duration gap. The proceeds on the cover assets therefore balance the interest and principal payments.

Section 45 (interdependent assets and liabilities) of the NSFR proposal from the BCBS should be amended in such a way that cover assets and covered bonds with the above characteristics (matching principle) should fall under its scope whereby national supervisors would have the discretion to set the RSF and the ASF to zero for cover assets and covered bonds, respectively.

In some jurisdictions the interdependency of cover assets and covered bonds is further supported by:

- 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.
- Mechanisms or triggers 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.

▪ *Treatment of covered bonds for investors*

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

The EMF-ECBC is also 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 Requirement (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. 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. 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%.

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.

Therefore, we do not support that covered bonds backed by cover pools of high credit quality are treated differently in NSFR because of differences in issue size as is the case for the Delegated Act on the Liquidity Coverage Requirement. In the Delegated Act both rating and issue size define the, short-term, liquidity of an asset. By not relying on issue sizes with respect to RSF treatment, it is ensured that covered bonds - backed by the same high quality cover pools - are fulfilling the same stable funding requirements.

2. *If a respondent is a bank, could you please quantify the level of your expected shortfall of stable funding, the changes to the composition of your balance sheet that may result from meeting the NSFR and what the impact of these changes may be on the European economy?*

Another concern for covered bond issuing companies is the lack of harmonisation between the ASF of the covered bond and the RSF of the encumbered assets as soon as the residual maturity for the covered bond is shorter than 1 year.

Adjusting towards compliance would be very difficult and entail increasing the level of capital significantly in order to meet the NSFR requirement even in cases where such capital levels are not necessary in light of other risks and capital requirements.

The ASF for the covered bond would be just 50% for the period 6 to 12 months before maturity and 0% for the rest of the period until maturity. The RSF of the encumbered mortgages would be 65% during the whole period from 12 months before maturity and until the maturity date (assuming long term mortgages). This would actually require such institutions to prefund any amounts 6-12 months ahead of the maturity of the covered bonds in order to keep the NSFR stable and above 100%. Of course, one could argue that a business model using ordinary senior bonds also would need to prefund in advance. However, by using senior bonds the institution does not need to use collateral. The covered bond issuing institution would need to "double up" the collateral pool to be able to prefund the necessary amount. However, that would not be enough due to the lack of harmonisation between ASF and RSF for such positions. In reality, the covered bond issuing institution would still need to be funded by own funds capital or ordinary senior bonds to cover the

gaps in order to keep the NSFR above 100%. As illustrated below, during the last 12 months before the covered bond's maturity date this would require significant amounts of such additional funding. The proceeds from such additional funding would be required to be invested outside the collateral pool in order to be unencumbered.

The examples below compares this situation for a specialist covered bond bank with an institution using unsecured financing to finance mortgage loans. In case of the covered bond bank we take into account the over-collateralisation level required by law.

Mortgage assets funded by covered bonds

Assets					RSF	Liabilities					ASF	NSFR
	<6M	6-12M	>12M				<6M	6-12M	>12M			
Retail mortgage	100	5	15	80	90	Own funds	5		5	5		
weight		50%	50%	100%		covered bonds	95	4,75	14,25	83,1		
	100				90	weight		0%	50%	100%		
							100			88,1	98%	

(a) (b) (b)/(a)

Mortgage assets funded by senior debt

Assets					RSF	Liabilities					ASF	NSFR
	<6M	6-12M	>12M				<6M	6-12M	>12M			
retail mortgage	100	5	15	80	62	Unsecured debt	100	5	15	87,5		
weight		50%	50%	65%		weight		0%	50%	100%		
	100				62		100			87,5	141%	

(a) (b) (b)/(a)

This example illustrates that it is almost arithmetically impossible for a special purpose mortgage covered bond institution to reach the NSFR threshold of 100%. That is despite the fact that there are ALM rules in covered bond legislation.

In the example above, achieving a 100% NSFR for a covered bond issuing institution would imply tripling own funds when this capital is not needed for liquidity or solvency purposes. In some jurisdictions, raising own funds and placing the revenue in short term liquid assets might have no benefits on NSFR, as then those short term liquid assets are placed in the cover pool, where they might be treated as fully encumbered OC (ASF=RSF=100%).

Assets					RSF	Liabilities					ASF	NSFR
	<6M	6-12M	>12M				<6M	6-12M	>12M			
Retail mortgage	100	5	15	80	90	Own funds	17		17	17		
weight		50%	50%	100%		covered bonds	83	4,15	12,45	72,6		
	100				90	weight		0%	50%	100%		
							100			89,6	100%	

(a) (b) (b)/(a)

Given the limited strategies available for covered bonds issuers to cover their NSFR shortfall, it is expected that the funding costs for these banks will increase significantly. These costs would likely be passed to the borrower, thereby increasing the costs of housing financing.

Derivatives transactions

- In light of previous consultations, could you provide substantiated evidence about possible issues caused by the application of the BCBS NSFR standard to derivative transactions at European level and which have not been taken into account at Basel level? If yes, what alternative treatment would you propose for NSFR calculation purposes to deal with the funding needs arising from derivatives transactions? If possible, please provide the impact on your institution of the alternative treatment you propose (as compared to the BCBS standards).

In the existing framework 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 covered bonds 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, whereas the counterparty does, when required. This is possible because the derivative product ranks *pari passu* to the covered bonds and has an equal claim on the cover pool. Indeed, cover pools are constructed in such a way to ensure that no stakeholder has a preferential right to the cover asset ahead of the covered bondholders.

Assigning these non-collateralised assets a 100% weighting seems inappropriate as it does not take into account the secured nature of the asset which has been recognised in other regulation, 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 consequently treated for the calculation of the NSFR, i.e. with a 0% RSF weighting. In the same way, the 20% RSF weighting for derivatives whose mark-to-market value 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.

4. *More specifically, regarding the 20% RSF factor applicable to gross derivatives liabilities, do you think it would be possible and appropriate to develop a more risk-sensitive approach that would take better account of the funding risk arising from banks' derivative activities over a one-year horizon? In that case, what could be this approach? Do you think that the use of the SA-CRR could provide an appropriate measure? If possible, please provide the impact on your institution of the alternative treatment you propose (as compared to the BCBS standards).*

The use of the 20% RSF factor related to gross derivative liabilities is not a good measure of the potential change in the funding requirements generated by the derivative portfolios. Negative market values do not indicate anything about the potential for future changes in the market values of the positions. It could be quite opposite: the larger the negative value already has become, the smaller the likelihood for a further reduction in market value might be. Changes in funding requirements are, in practice, based on the total netting between all transactions/all positions and all counterparties. SA-CCR is a measure of potential changes for individual customers/counterparties and thus only based upon a netting between derivative positions between the bank and that counterparty. Thus, an approach with SA-CCR will not take into account important netting of funding effects across all counterparties. In this context, SA-CCR is viewed to significantly overestimate the risk of changes in funding requirements and it will not act as a good measure of the risk of changes in the funding requirements.

Covered bond institutions should therefore be exempted from the application of a 20% RSF factor. A floor based-approach would possibly be more fit for purpose, i.e. to ensure that the risk of funding requirements related to derivatives are properly taken into account as the net derivative amounts might be small at a given reporting date. However, in such a case the RSF factor needs to be appropriately calibrated, and we question the reasons and background for the choice of the 20% level for this RSF.

Failure to implement amendments in this area could threaten the ability of covered bonds 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.

5. *If you propose special treatment for specific activities (eg hedging instruments, clients clearing...), how would you define these activities?*

Derivatives that are adequately used for hedging purposes/perfect hedge should be exempted from the NSFR calculations. Differences in market values due to credit spread differences should in any event qualify for exemption. Maturity differences seem not to be accounted for. The 20% RSF requirement for all transactions has the effect that even positions with a very short remaining maturity will require long-term funding. Positions with a short remaining maturity, for example less than one year, should therefore be excluded from the calculations.

Short term transactions with financial institutions

6. *In light of previous consultations, could you provide substantiated evidence about possible issues caused by the application of the BCBS NSFR standard to short term transactions with financial institutions at European level and which have not been taken into account at Basel level? If yes, what alternative treatment would you propose for NSFR calculation purposes to deal with the funding needs arising from short-term transactions with financial institutions? If possible, please provide the impact on your institution of the alternative treatment you propose (as compared to the BCBS standards).*
7. *If you propose special treatment for specific activities (e.g. client's short facilitations activities, prime brokerage businesses...), how would you define these activities?*

Application of the proportionality principle

8. *What do you believe the appropriate level of application of the NSFR to be? Is there scope to make the NSFR requirements more proportionate and, if so, on the basis of what criteria?*
9. *In particular, what criteria could be used to define institutions with a "low liquidity risk profile"? What simplified metrics (e.g. core funding ratio close to loans to deposits + capital) could be used to identify these institutions? Should certain institutions be completely exempted from the NSFR and on what basis?*

As a result of the key safety features, including a strict legal and supervisory framework, asset segregation and an actively managed cover pool, which characterise covered bonds, covered bond issuing institutions should be defined as a low liquidity risk profile institution. Covered bond institutions, where in addition payment imbalances between assets and covered bonds are capped by law (matching principle), as is the case in several jurisdictions in Europe, present an even lower risk.

Furthermore, as indicated above, in the Basel definition of NSFR, mortgage loans funded by covered bonds are regarded as encumbered and hence receive a higher RSF weight, compared to mortgage loans funded by e.g. shorter term senior bonds. This provides wrong incentives for banks funded by covered bonds to replace covered bonds by shorter term senior bonds. Some covered bond issuing institutions are required to be set up as separate legal entities and they are not allowed to take deposits from clients. Therefore, in addition, those institutions usually do not have other funding sources than covered bonds and may hence have difficulties to meet the NSFR requirement at solo levels.

For these reasons, specialist covered bonds institutions should be completely exempted from the NSFR on a standalone basis. When consolidated within a banking group, the cover pool and its related liabilities should be viewed as a pass through business model, i.e. be associated to a 100% NSFR.