

11th of May 2016

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

I. Executive Summary

- The European Mortgage Federation-European Covered Bond Council (EMF-ECBC)¹ is concerned that the Basel Committee on Banking Supervision's (BCBS) NSFR proposals would unduly restrict the covered bond market and therefore long-term financing.

Situations where there are interdependent cover assets & covered bonds

- We welcome the EBA recommendation in its December 2015 Report² on the NSFR that certain EU specificities should be taken into account in the transposition of the NSFR into the EU banking framework, including pass-through models.
- The EMF-ECBC supports the option for national supervisors to identify assets and liabilities which are interdependent and set the Required Stable Funding (RSF) and the Available Stable Funding (ASF) to zero for such assets and liabilities.
- We welcome the EBA recommendation that fully matched funded amortised mortgage lending should receive the same treatment as interdependent assets and liabilities as envisaged in the Basel Standard (para. 45), but believe this treatment should be extended to all situations where the matching principle exists in law.

Situations where there are no interdependent cover assets & covered bonds

- In the case of structures where there are no interdependent assets and liabilities, consideration should be given to the following:
 - Derogation from NSFR on an individual basis: We strongly support the EBA's advice to allow for a waiver of the application for individual institutions and subject them to a consolidated requirement at a group or sub-group level, in the interests of effective liquidity management.
 - Treatment of covered bonds with residual maturity below 1 year:
 - o The issuance of covered bonds is penalised under the NSFR when the residual maturity of the covered bond falls under 1 year, with cliff effects at the 1 year and 6 months' points. This means that institutions relying on covered bonds for the funding of mortgage loans might face a funding deficit during these periods. In fact, it is almost arithmetically impossible for a pure mortgage covered bond institution to reach the 100% NSFR threshold.

¹Established 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 €6.9 trillion at the end of 2014. As of February 2016, the EMF has 19 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 including covered bond issuers, analysts, investment bankers, rating agencies and a wide range of interested stakeholders. As of February 2016, the ECBC has over 100 members across 25 active covered bond jurisdictions and many different market segments. ECBC members represent over 95% of covered bonds outstanding, which were worth over €2.5 trillion at the end of 2014. The EMF-ECBC is registered in the EU Transparency Register under ID Number 24967486965-09.

² EBA Report dated 15 December 2015 on Net Stable Funding Requirements under Article 510 of the CRR.

- o The ASF factors for covered bonds should be adjusted upwards to better reflect the true funding behaviour of covered bonds. The ASF factors assigned by the BCBS to covered bonds are very low, particularly compared to those on stable and less stable deposits and/or term deposits provided by retail and SME customers.
 - o The NSFR in its current wording does not distinguish between secured and unsecured wholesale funding as all short-term capital market funding is treated as unstable funding.
 - o It is not clear how funding instruments with an issuer option to extend maturity will be treated. Instruments such as bonds with soft bullets, with conditional pass through or with a regulatory trigger for maturity extension should be considered long-term stable funding. From an investor's perspective, however, positions in instruments with a conditional maturity extension option should not give rise to a higher level of RSF. This is because there is only a chance of the maturity being extended, rather than a certainty.
- Treatment of assets encumbered by covered bond issuance:
- o Applying an encumbrance discount to mortgages in the cover pool resulting in a 100% RSF ignores the specifics of the covered bond framework and creates two biases: (i) the NSFR favours deposits over capital market based funding, and (ii) it favours unsecured debt over secured debt. RSF weightings should be identical whether an asset is funded through covered bonds or not.
 - o Assigning an unfavourable weight to assets funded by covered bonds on the grounds of their lesser liquidity again ignores the specifics of the covered bond framework, because there is no acceleration of payment obligations in the event of issuer default.
 - o If an encumbrance "discount" were deemed necessary, the cover pool encumbrance should always be treated from a portfolio perspective.
 - o The value of the over-collateralisation of the cover pool should be treated as unencumbered.
- Treatment of swap agreements on covered bonds: Assigning these non-collateralised assets a 100% RSF weighting is not justified because it does not take into account the secured nature of the asset. The protection offered by the cover pool and the absence of swaps termination should be considered as cash-like collateral and these agreements should receive a 0% RSF, as should derivatives of which the market-to-market value is negative because the issuer does not post any collateral and thus there is no need to finance it.

Treatment of covered bonds for investors

- The EMF-ECBC is strongly supportive of the fact that extremely high liquidity and quality and high liquidity and quality covered bonds are assigned RSF factors in line with their categorisation under the European Commission's Delegated Act on the Liquidity Coverage Requirement³.
- The EMF-ECBC endorses the fact that the NSFR rightfully acknowledges that the appropriate stable funding requirements of a covered bond mainly rely on the credit quality.
- Therefore, we do not support that covered bonds backed by cover pools with high credit quality are treated differently in the NSFR because of differences in issue size, as is the case for the DA on the LCR, in which 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 issued from the same prime cover pools fulfil the same stable funding requirements.

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

II. General remarks

1. The EMF-ECBC 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."*⁴ 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. We welcome the EBA recommendation in its Report⁵ on the NSFR published in December 2015 that certain EU specificities be taken into account in the transposition of the NSFR into the EU banking framework, including pass-through models.
3. However, for the reasons outlined hereafter, we are concerned that the EBA underestimates the impact of the NSFR when it suggests that *"The analysis carried out did not reveal strong statistical evidence of any significant detrimental effects of the NSFR on bank lending, financial assets markets or trading book positions in banks, other than some possible adjustment in prices"*.

III. Situations where there are interdependent cover assets & covered bonds

4. 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 Required Stable Funding (RSF) and the Available Stable Funding (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.
5. 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 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 this respect, we welcome recommendation 6 in the EBA's recently published Report on the NSFR that fully matched**

⁴ 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/0MTjCQ>.

⁵ EBA Report dated 15 December 2015 on Net Stable Funding Requirements under Article 510 of the CRR.

funded amortised mortgage lending receives the same treatment as interdependent assets and liabilities as envisaged in the Basel Standard (para. 45), but believe that this treatment should be extended to all situations where the matching principle, as described in point 4 above, exists in law.

6. 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.

We welcome that the EBA in its Report states that, in some cases, the existence of an extendable maturity trigger on the pass-through bond mitigates the inherent funding risk of maturity imbalances. We believe that this fully corresponds to a fully match funded amortised mortgage lending model and should be treated as such.

IV. Situations where there are no interdependent assets & liabilities

In the case of structures where there are no interdependent assets and liabilities, consideration should be given to the following:

Derogation from NSFR on an individual basis

7. In the context of EU groups or sub-groups where liquidity/funding is centrally managed, a net stable funding requirement at an individual level could impede effective liquidity management. To avoid this problem, we strongly support the EBA's advice to allow for a waiver of the application of the NSFR for individual institutions and subject them to a consolidated requirement at a group or sub-group level based on conditions consistent with those for the LCR (laid down in Articles 8 and 10 of the CRR).

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

8. 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
≥ 1 year	100%
< 1 year and ≥ 6 months	50%
< 6 months	0%

9. It is clear that two cliff effects are created: one at the 1 year point, and the other at the 6 months' point, where the covered bond will no longer count as Available Stable Funding (ASF). 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, on which the NSFR as defined by the BCBS is excessively reliant. In fact, it is almost arithmetically impossible for a pure 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. This concern is highlighted by the EBA on page 140 of its Report on the NSFR.

10. 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. With this in mind, the ASF factors assigned to covered bonds in the BCBS proposal are 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.
11. Linked to this point and as implied above, the NSFR in its current wording 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.
12. 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 RSF. This is because there is only a chance of the maturity being extended, rather than a certainty. So unless the new RSF factors reflect as well the probability of the maturity extension the RSF should not change for the investor.
13. Further, from an investor perspective, it is important to notice 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.

Treatment of assets encumbered by covered bond issuance

14. With regards to asset encumbrance arising from the issuance of covered bonds, this product is typically backed by a pool of mortgages⁶. Applying an encumbrance "discount" to mortgages in the cover pool resulting in a significantly less favourable treatment, a 100% RSF, due to them being funded via covered bonds, ignores the fact that covered bond pools are subject to over-collateralisation requirements and that cover assets in covered bond cover pools are able to generate liquidity to pay covered bond holders. RSF weightings on identical assets on the balance sheet should not depend on how the assets are funded. The encumbrance "discount" means that: (i) the NSFR favours deposits over capital market based funding, suggesting that the former is more stable which is debatable, especially in the case of covered bonds which are a particularly stable form of funding, and (ii) that it furthermore favours unsecured debt over secured debt. In fact, 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

⁶ For the sake of simplicity, public sector and other type of loans will not be mentioned in the rest of this paper.

specialised ones. We believe that both biases are undesirable and that, as a result, RSF weightings should be identical whether an asset is funded through covered bonds or not.

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 an unfavourable weight to assets funded by covered bonds, on the grounds of their lesser liquidity, ignores the specifics of the covered bonds framework. Moreover, in a number of jurisdictions covered bond issuers are subject to specific assets liabilities management and liquidity risk rules which limit maturity transformation of positions. In a 2014 publication⁷, the EBA encourages the different legislative bodies to take account of these rules in their regulatory framework. To recall, the NSFR aims to limiting the maturity transformation. Thus, it should have a very limited impact on covered bond issuers.
16. In case the regulator were to deem 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.
17. 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 should 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 or liquidity that are used for the overcollateralisation of the pool (be it 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.

The treatment of swap agreements on covered bonds

18. 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.
19. Assigning these non-collateralised assets a 100% RSF weighting is not justifiable as it does not take into account the secured nature of the asset. The secured profile of these products has been recognised in other regulatory statements, e.g. the EMIR RTS proposal. Thus, the protection offered by

⁷Opinion of the EBA on the preferential capital treatment of covered bonds (EBA/Op/2014/04), <https://www.eba.europa.eu/documents/10180/657547/EBA-Op-2014-04+Covered+Bond+Opinion.pdf>

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. The failure to implement this amendments, 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.

V. Treatment of covered bonds for investors

20. 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.
21. 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 (DA) on the Liquidity Coverage Requirement (LCR, published on 10/10/2014), extremely high liquidity and quality covered bonds should be treated as Level 1 assets, and thus fall under the 5% RSF category of the NSFR.
22. Similarly, high liquidity and 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.
23. 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%.
24. The EMF-ECBC endorses the fact that the NSFR rightfully acknowledges that the appropriate stable funding requirements of a covered bond mainly relies on the credit quality.
25. Therefore, we do not support that covered bonds backed by cover pools with high credit quality are treated differently in the NSFR because of differences in issue size, as is the case for the DA on the LCR. In the DA, both rating and issue size define the short-term liquidity of an asset.
26. 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.

VI. Other remarks

27. 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.
28. For credit institutions which have a mix of funding sources (covered bonds, unsecured bonds, deposits, etc.) and which need to raise the NSFR, these credit institutions will be obliged to reduce their use of stable funding (covered bonds) because of the NSFR, and instead use less stable funding sources, such as unsecured bonds. This will result in higher funding costs, meaning that the NSFR will also lead to shorter maturity in funding when the yield curve has a positive slope, which is rather common. For credit institutions that use covered bonds as a funding source when they are in a stressed liquidity situation, this use of covered bonds means that the NSFR will be lowered. This cannot have been the intention of the BCBS.

29. The current design of the NSFR, albeit rightly fostering long term funding, may have a potential negative impact on the price and volatility of good short term instruments. Financial institutions with low NSFR might, in fact, quickly shift to other funding methods which enhance the ratio.
30. In the case of retail banking, the negative impact of the NSFR could occur in two ways:
- a. A reduction of the lending capacity to the economy (households and enterprises) as a consequence of the need to maintain liquid assets.
 - b. An increase of the balance sheets that makes difficult the management of the liquidity and leverage ratios.
-