

European Mortgage Federation European Covered Bond Council (EMF-ECBC)

Position Paper

May 2017

EMF-ECBC Position Paper on Relevant Aspects of the EU Banking Reform with a focus on the Amendments to the Capital Requirements Regulation

Executive Summary

1. The European Mortgage Federation-European Covered Bond Council (EMF-ECBC)¹ welcomes the objective of the European Commission's banking reform package to complete the post-crisis regulatory agenda by making sure that the regulatory framework addresses any outstanding challenges to financial stability, while ensuring that banks can continue to support the real economy.
2. 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.
3. The EMF-ECBC has already commented on this banking reform package with a [short position paper](#) on the treatment of interdependent assets and liabilities in the Net Stable Funding Ratio (NSFR) framework introduced by the European Commission's Proposal.
4. In addition to its comments with regards to NSFR, the EMF-ECBC would like to make the following recommendations aiming to improve the package and ensure its smooth implementation:
5. In the Commission's proposal for the Review of the Trading Book, a 20 day liquidity horizon under the Internal Model Approach and a 200 bps Credit Spread Risk (CSR) charge shock in the SA dramatically overstate the credit spread risk for many of the EU's largest Covered bond markets, even though they mark an improvement from the Basel proposal. Thus, covered bond risk weights for credit spread risk should be more granular and consistent across the framework.
6. In order to ensure consistency between Credit Risk and Market Risk, the LGD to calculate the default risk charge of Covered bonds, should be 11,25%.

¹ Established in 1967, the 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 7.0 trillion EUR at the end of 2015. As of October 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 ECBC, a platform bringing together Covered bond issuers, analysts, investment bankers, rating agencies and a wide range of interested stakeholders. As of October 2016, the ECBC has over 100 members across 26 active Covered bond jurisdictions and many different market segments. ECBC members represent over 95% of Covered bonds outstanding, which were worth nearly 2.5 trillion EUR at the end of 2015. The EMF-ECBC is registered in the EU Transparency Register under the ID Number 24967486965-09.

7. The BCBS 0,03 % Probability of Default (PD) floor within the Internal Model Approach for Default Risk Charge (IMA DRC) is retained in CRR2 (article 325bq (5)). We suggest instead to remove the floor in order to retain a risk sensitive approach to the IMA and not excessively charge for the default risk on highly rated government and Covered bonds.
8. With regards to the introduction of the IFRS9, to maintain a level playing field between American and European financial institutions, the EMF-ECBC proposes that, in the period from January 2018 to December 2019, EU banks should be able to include in CET1 capital an adjustment amount of 100%. The five year transition should start from then on.

I. Treatment of Covered bonds in the trading book

Credit Spread Risk for Covered bonds – Article 325ai

9. In the Commission's proposal, Covered bonds issued in the Member States are subject to a 20 day liquidity horizon under the Internal Model Approach and a 200 bps Credit Spread Risk (CSR) charge shock in the SA. While the Commission's proposal represents an improvement from the BCBSs calibration, the revised risk weights still dramatically overstate the credit spread risk for many of the EU's largest Covered bond markets.
10. We recommend applying separate risk weights to each Credit Quality Step (CQS) [1, 2 and 3], starting at 75bps for CQS 1 and scaling up to 200bps for CQS 3. This would be better aligned with stressed performance and fully capitalises stressed risk scenarios under the FRTB SBA. Alternatively, a single split of the CSR charge for CQ1 and CQ2-3 Covered bonds respectively, could be applied.
11. The Table A below compares the largest measured historical credit spread moves to the risk weight for credit quality step 1 to 3 issuances in the different risk buckets used in the CSR (non-securitisation) delta calculation. Time series of financial data recorded during the crisis were used to estimate the aforementioned moves. This shows that the assigned risk weight for the financial and non-financial credit quality step 1 to 3 risk buckets used in the CSR delta quite accurately reflects actual largest historical credit spread moves. This is in sharp contrast to Covered bonds issued by, a selection of, Member States in credit quality step 1 where the CSR delta risk weight is between 2.99 and 6.25 times above the largest historical move. The historical spread moves are calculated using the liquidity horizons laid out in Article 325be Table 2, i.e. 40-day changes in spreads for investment grade corporate bonds and 20-day changes in spreads for investment grade Covered bonds issued by Member States.

Table A

Risk Bucket	Index	Largest Historical credit spread move	SBA risk weight	SBA RW vs Historical move	Proposed Risk Weight	Proposed RW vs Historical move
Financials, Credit Quality Step 1-3	JP Morgan US Financials (Spread to Libor)	490 bp	500 bp	1.02x	Unchanged	1.02x
Non-Financials, Credit Quality Step 1-3	JP Morgan US Non-Financials (Spread to Libor)	293 bp	150-300bp Average: 238bp	0.81x	Unchanged	0.81x
Covered Bonds, Credit Quality Step 1	Danish, Floater	32 bp	200 bp	6.25x	75 bp	2.34x
	Danish, Capped floaters	48 bp	200 bp	4.16x	75 bp	1.56x
	Danish, Non-callables	59 bp	200 bp	3.39x	75 bp	1.27x
	Danish, callables	67 bp	200 bp	2.99x	75 bp	1.12x
	German Pfandbrief 2Y	43 bp	200 bp	4.65x	75 bp	1.74x
	German Pfandbrief 5Y	37 bp	200 bp	5.41x	75 bp	2.03x
	German Pfandbrief 7Y	44 bp	200 bp	4.55x	75 bp	1.70x
	Swedish, 2Y	67 bp	200 bp	2.99x	75 bp	1.12x
	Swedish, 5Y	49 bp	200 bp	4.08x	75 bp	1.53x
	Bloomberg Covered Bonds Index	60 bp	200 bp	3.33x	75 bp	1.25x
	JP Morgan Pfandbriefe Index (asset swap spread)	40 bp	200 bp	5.00x	75 bp	1.88x

12. Also the current Standardised Approach states in Art. 336 CRR that institutions may calculate the specific risk requirements for any bond qualifying for a 10% risk weight in accordance with the treatment set out in article 129 (4), (5) and (6) as half of the applicable specific risk own funds requirements. The appropriateness of this treatment was recently confirmed by the European Commission in its "Report from the Commission to the European Parliament and the Council - on Article 503 of Regulation (EU) No 575/2013 Capital requirement for Covered bonds" (2015, p. 2) .
13. This illustrates that the 200 bp risk weight for CSR delta applied to credit quality step 1 Covered bonds issued by, the selection of, Member States under the SA requires a substantial adjustment to be more reflective of their true risk and to resolve inconsistencies in the treatment of the different asset classes within the framework.

Proposed amendments

14. Article 325ai – risk weights for credit spread risk (non –securitisations).

In table 4, the bucket 9 is replaced by:

Bucket number	Credit quality	Sector	Risk weight
9		<i>Credit Quality Step 1 Covered bonds issued by credit institutions in Members States</i>	0,75 %
		<i>Credit Quality Step 2 Covered bonds issued by credit institutions in Members States</i>	1,25 %
		<i>Credit Quality Step 3 Covered bonds issued by credit institutions in Members States</i>	2,0 %

Or alternatively, in table 4 bucket 9 is replaced by one of the following:

Bucket number	Credit quality	Sector	Risk weight
9		<i>Credit Quality Step 1 Covered bonds issued by credit institutions in Members States</i>	0,75 %
		<i>Credit Quality Step 2 - 3 Covered bonds issued by credit institutions in Members States</i>	2,0 %

Default Risk Charge for Covered bonds – Article 325x

15. To calculate the default risk charge, a Loss Given Default (LGD) of 25% shall be assigned to Covered bonds. This LGD provision differs significantly from the F-IRBA provision in Art. 161 CRR, which assigns a LGD of 11,25% to Covered bonds. **As this parameter cannot be interpreted differently for Credit Risk and Market Risk the LGD to calculate the default risk charge of Covered bonds, should be 11,25%.**

The Default Risk Charge for Sovereigns and Covered bonds – Article 325bq

16. The BCBSs 0,03 % Probability of Default (PD) floor within the Internal Model Approach for Default Risk Charge (IMA DRC) is retained in CRR2 (article 325bq (5)). This risk insensitive approach overstates the capital charge for highly rated government and Covered bonds' jump-to-default risk, while affecting lower quality/rated sovereign and Covered bonds to a much lesser extent.
17. This single measure alone will seriously challenge the business case for running market-making operations in government and Covered bonds. The additional (capital) cost cannot be reasonably recouped. This in turn could have major implications for liquidity in these markets and increase funding costs for the government and mortgage holders. This could also impact financial stability, given that these high quality liquid assets (HQLAs) are used as liquidity buffers, financial collateral, etc.
18. The DRC PD floor will significantly increase the capital requirements for holding highly rated, e.g. AAA rated government and Covered bonds, even though there is no valid reason to suggest that there is a significant shortfall of capital held against these high quality assets. The DRC measure makes up a significant proportion of banks' total IMA capital requirement.
19. Therefore, the EU Commission's good intentions to provide a better treatment for EU government and Covered bonds in the amendments to the CRR (through reduced liquidity horizons and risk weight) will have very little overall effect given the magnitude of the DRC.
20. We would suggest instead **to remove the floor in order to retain a risk sensitive approach to the IMA and not excessively charge for the default risk on highly rated government and Covered bonds.**

II. Implementation period of IFRS 9

Introduction of IFRS 9 – Article 473a

21. The European Commission has proposed in Article 473a of the amendments to the CRR package a five years period to enable banks to amortize the impact of IFRS9 on regulatory capital.

22. American banks will adopt the corresponding US accounting standard only from 2020. Accordingly, **EMF-ECBC proposes that, in the period from January 2018 to December 2019, European banks should be allowed to include in CET1 capital an adjustment amount of 100%. The five years period transition should start from then on.**