

European Mortgage Federation European Covered Bond Council¹ (EMF-ECBC)

Proposals for Amendment

19 January 2018

EMF-ECBC Proposals for Amendment to the European Commission's Proposal for a Regulation amending Regulation (EU) No 575/2013 and Regulation (EU) No 648/2012

I. NSFR

- ASF treatment of covered bonds – Article 428l CRR - Higher ASF for covered bonds with with a residual contractual maturity of less than one year

<u>Current draft:</u>	<u>Proposed draft:</u>
Article 428l - 50% available stable funding factor By way of derogation from Article 428k, the following liabilities shall be subject to a 50% available stable funding factor: [...] (d) any other liabilities with a residual maturity of minimum six months and less than one year not referred to in Articles 428m to 428o.	Article 428l - 50% available stable funding factor By way of derogation from Article 428k, the following liabilities shall be subject to a 50% available stable funding factor: (d) covered bonds as referred to in Article 52(4) of Directive 2009/65/EC or covered bonds that meet the eligibility requirements for the treatment set out in Article 129(4) or (5) and with a residual contractual maturity of less than one year. (e) any other liabilities with a residual maturity of minimum six months and less than one year not referred to in Articles 428m to 428o.

1. Covered bonds, with their unique structure, transparency and safety features represent the most stable, and available, funding tool for EU based financial institutions. European banks use them to channel long-term private funding into the real economy in a stable and countercyclical way. These key characteristics have been proven to be true over the last crises.
2. As such, covered bonds are very resilient instrument which guarantees a certain ease in refinancing, even in difficult market conditions, **we believe that a 50% ASF for all covered bonds as referred to in Article 52(4) of Directive 2009/65/EC or covered bonds that meet the eligibility requirements for the treatment set out in Article 129(4) or (5) and with a residual contractual maturity of less than one year would be warranted.**

¹ Established in 1967, the EMF is the voice of the European mortgage industry, representing the interests of mortgage lenders 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 2016. As of October 2016, the EMF has 16 members across 13 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 2017, 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.

▪ **RSF treatment of cover assets – Article 428af CRR - 85% RSF for all encumbered cover assets & mandatory OC**

<u>Current draft:</u>	<u>Proposed draft:</u>
Article 428af - 85% required stable funding factor The following assets shall be subject to a 85% required stable funding factor: [...]	Article 428af - 85% required stable funding factor The following assets shall be subject to a 85% required stable funding factor: [...] h) encumbered assets with a residual maturity of one year or more in a cover pool funded by covered bonds as referred to in Article 52(4) of Directive 2009/65/EC or covered bonds that meet the eligibility requirements for the treatment set out in Article 129(4) or (5)

3. The intent of the regulator to limit maturity transformation is clear and, in our view, valuable. However the EMF-ECBC believes that the NSFR treatment of cover assets should depend less on their funding method and that there should be equal treatment for assets in the cover pool of covered bonds. This is because:

- In the form prescribed, the NSFR favours deposits over capital market based funding, suggesting that the former is more stable, which is debatable, especially since covered bonds are a particularly reliable form of funding;
- It furthermore favours unsecured debt over secured debt. In fact, an identical asset receives a better weighting if backed by unsecured debt than if backed by a covered bond. This not only goes against the principle of a level playing field, as it penalises covered bond (and other secured funding like securitisation) issuers, but it also incentivises a shift towards shorter dated and more expensive unsecured funding. The positive NSFR treatment of senior unsecured funding results in an incentive to fund the bank with senior unsecured debt and in order to lower the funding spread also to shorten the maturity. This will result in the use of a less stable funding product with a shorter maturity instead of long dated covered bonds, despite the latter having demonstrated over the years that they are a solid and resilient long-term funding tool. This is counterproductive from a financial stability point of view and puts European financial institutions at a disadvantage vis-à-vis players in other jurisdictions, where funding is more reliant on unsecured funding. As such, we believe that the biases described in this point and the one above should be reduced;
- We also believe that the case of covered bond issuers, and, in particular, specialised covered bonds issuers, where almost the entire asset base is encumbered under the current legislative proposal, was not taken into account when calibrating the proposed RSF weightings.

4. For these reasons, **in order to maintain the incentive to reduce maturity transformation and, at the same time, preserve, to the extent possible, a level playing field between funding sources we propose to reduce the discrimination between assets inside and outside the cover pool by lowering the RSF for encumbered assets.**

▪ **Treatment of overcollateralization in the cover pool - Articles 411 & Articles 428p CRR - Definition of overcollateralisation and treatment of liquid assets**

<u>Current draft:</u>	<u>Proposed draft:</u>
Article 411 – Definitions [...] (6) 'non-mandatory overcollateralisation' means any amount of assets which the institution is not obliged to attach to a covered bond issuance by virtue of legal or	Article 411 – Definitions [...] (6) 'non-mandatory overcollateralisation' means any amount of assets which the institution is not obliged to attach to a covered bond issuance by virtue of legal or

regulatory requirements, contractual commitments or for reasons of market discipline, including in particular where: (a) the assets are provided in excess of the minimum legal, statutory or regulatory overcollateralisation requirement applicable to the covered bonds under the national law of a Member State or a third country; (b) pursuant to the methodology of a nominated ECAI, the assets are not required for the covered bonds to maintain their current credit assessment; (c) the assets are not required for material credit enhancement purposes;	regulatory requirements or contractual commitments or for reasons of market discipline, including in particular where: (a) the assets are provided in excess of the minimum legal, statutory or regulatory overcollateralisation requirement applicable to the covered bonds under the national law of a Member State or a third country; (b) pursuant to the methodology of a nominated ECAI, assets are not required for the covered bonds to maintain their current credit assessment that can be sold without impairing the future ability of the institution to issue new covered bonds. (c) the assets are not required for material credit enhancement purposes;
Article 428p – Calculation of the amount of required stable funding [...] (4) <i>The following assets shall be considered to be unencumbered:</i> [...] (c) <i>assets attached as non-mandatory overcollateralisation to a covered bond issuance.</i>	Article 428p – Calculation of the amount of required stable funding [...] (4) The following assets shall be considered to be unencumbered: [...] (c) all assets attached as non-mandatory overcollateralisation and level 1 and 2 assets, as referred to in Articles 10, 11 and 12 of Commission Delegated Regulation (EU) 2015/61, attached as mandatory overcollateralisation to a covered bond issuance.

Non-mandatory over-collateralisation – article 411

1. OC levels indicated by rating agencies as sufficient to maintain a current rating of covered bonds (rating OC) are defined as mandatory OC in NSFR. And thus encumbered.
2. With this definition the rating OC is treated as assets which are tied up and may not be used by the covered bond issuer to obtain additional liquidity.
3. Such a treatment of the rating OC is not correct. Typically, the covered bond issuer has not taken any contractual, legal or regulatory commitment to maintain its rating at a certain level. The issuer is fully free to use the cover pool assets to raise funding through sales or repurchase agreements.
4. Furthermore, this treatment will create a cliff effect if the OC indicated by rating agencies as sufficient to maintain a current rating is considered to be encumbered. The problem is aggravated in situations where the level of sufficient OC changes significantly over a short period – typically due to changes in methodology. In such a situation the institutions potentially will become unable to meet the minimum NSFR requirement because the increasing rating OC requires 100 % required stable funding. Alternatively, the institutions could be forced to accept lower ratings.
5. Covered bond issuers will thus be faced with a choice between accepting a lower rating or failing to meet the NSFR requirement for a period. Consequences would be reduced financial stability with possible negative effects on supply of loans for growth and welfare.

6. To avoid such a situation and the reliance on ratings in the legislation it would be necessary to amend the definition of “non-mandatory overcollateralisation in article 411 in CRR as indicated above and suggested in the EMF-ECBC position paper on NSFR from October 2017.

Treatment of liquid assets – article 428p

1. There is a level playing field problem in the NSFR concerning the treatment of level 1 and 2 assets (as defined in the LCR) depending on whether the assets are in a non-deposit taking specialised mortgage bank or a universal bank. The problem relates to the treatment of covered bonds’ mandatory OC in NSFR.
2. A non-deposit taking specialised mortgage bank can only fund OC for covered bonds with equity and other wholesale debt instruments such as capital instruments and senior debt. The revenue of these instruments can be placed in level 1 and 2 assets. This means that the stock of liquid assets (LCR level 1 and 2 assets) of a non-deposit taking specialised mortgage bank also typically counts as OC. This is not the case in a universal bank. A universal bank will often add additional mortgage loans funded by deposits as OC to the cover pool for cover bonds and level 1 and 2 assets will not be part of the cover pool.
3. This treatment of mandatory OC (including level 1 and 2 assets in LCR) as encumbered assets in NSFR implies that the stock of liquid assets in non-deposit taking mortgage banks are tied up whereas the same stock of liquid assets in universal banks will be considered available. Further such treatment in non-deposit taking mortgage banks is in conflict with the purpose of liquid assets, since these assets constitute a liquidity risk mitigation tool related to the covered bond issuance. The assets can be used to generate liquidity.
4. For specialised mortgage banks this will add an extra cost compared to universal banks and render mortgage loans more expensive.
5. To secure equal treatment not depending on the type of business model, an amendment of article 428p in CRR is needed as indicated above and suggested in the EMF-ECBC position paper on NSFR from October 2017.

II. Treatment of Covered Bonds in the Trading Book

▪ Credit Spread Risk for Covered bonds – Article 325ai

1. 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.**
2. **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.
3. 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) .
4. 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.
5. **With regard to Article 325ai – risk weights for credit spread risk (non –securitisations) – we specifically propose the following amendment (and potential alternative):**

In table 4, bucket 9 is replaced by:

<i>Bucket number</i>	<i>Credit quality</i>	<i>Sector</i>	<i>Risk weight</i>
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:

<i>Bucket number</i>	<i>Credit quality</i>	<i>Sector</i>	<i>Risk weight</i>
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 %

III. New Risk Weights for Residential Mortgage Exposures

The EMF-ECBC strongly supports the proposal in Article 1(1)(52b)(new) of the draft ECON Report for a new standardised risk weight for exposures secured by residential mortgages of 20% up to 75% LTV and of 35% between 75% and 100% LTV. This proposed treatment appropriately reflects the low risk nature of the residential mortgage business and is aligned with the recommendations of the recently published Basel III Reform Package which similarly takes account of the specific risk profile of this type of lending.

IV. Green Supporting Factor

The EMF-ECBC welcomes the recognition in the draft ECON report of the importance of stimulating investment in green assets as part of the EU's broader sustainable energy agenda. **Indeed, the EMF-ECBC strongly believes that it would be appropriate to follow a risk sensitive approach and facilitate an alignment of capital requirements with a de-risking factor on the basis of clear and strong evidence of the lower risk of energy efficient mortgages.**

In this respect, the EMF-ECBC would like to draw the European Parliament's attention to the Horizon 2020 funded [Energy Efficient Mortgage Action Plan \(EeMAP\)](#), which is being led by the EMF-ECBC and which aims to create a standardised "**energy efficient mortgage**", according to which building owners are incentivised to improve the energy efficiency of their buildings or acquire an already energy efficient property by way of preferential financing conditions linked to the mortgage. At the heart of the Initiative is **the assumption that energy efficiency has a risk mitigation effect for banks as a result of its impact on a borrower's ability to service their loan and on the value of the property**. This means that energy efficient mortgages will represent a lower risk on the balance sheet of banks and could, therefore, qualify for a better capital treatment. Lower capital requirements deliver a strong incentive for banks to enter the market and, as a result, drive a broader incentive chain, in which all stakeholders, including EU citizens, issuers, investors and society as a whole, derive a concrete benefit.

In 2018, EeMAP will enter **an important pilot phase**, during which a energy efficient mortgage product ‘prototype’ will be trialled with approximately 25 banks in the EU with a view to collecting and analysing real time loan performance data according to energy efficiency of the mortgaged building. In this respect, a second Horizon 2020 funded project, **the Energy Efficient Data Protocol & Portal (EeDaPP), which is also being led by the EMF-ECBC, will in parallel deliver the infrastructure for the processing and analysis of the data collected**. It is anticipated that, together, EeMAP and EeDaPP, will make a significant contribution in the short term to mobilising private finance for investment in energy efficiency and, in the long run, will produce a solid evidence base of the de-risking effect of energy efficiency on mortgage lending, potentially resulting in the realignment of capital requirements described above.
