European Commission

FINANCE DENMARK

Memo

May 16, 2018
Doc. no. 581988-v1

Initiative on an integrated covered bond framework

Finance Denmark represents the Danish issuers of covered bonds – one of the largest covered bonds jurisdictions globally. Finance Denmark welcomes the adoption on 12 March 2018 of the European Commission's proposal on a covered bond framework, which aims at completing the Capital Markets Union in Europe.

It is our assessment that the European Commission has succeeded with a balanced approach to harmonization and it is important to keep these features in the final framework. In our view, it is a good foundation on which to build a European covered bond framework.

It is important that the covered bonds legislation underpins the very high quality of covered bonds compared to other types of funding by setting requirements to the assets that can collateralize the issued covered bonds. Any dilution of the covered bonds by broadening the asset classes should be avoided. A broader asset base should be in a funding instrument like the European Secured Note (ESN) that is clearly distinguished from covered bonds. This approach will provide businesses with an additional tool e.g. ESNs to finance assets that are out of the scope for covered bonds financing. At the same time, the high quality of covered bonds can be maintained.

The proposal defines the core elements that characterize covered bonds and preserves the special public supervision of issuers of covered bonds. These requirements will help to provide a high degree of security for investors, which is the key in providing cheap and stable funding to homeowners and businesses.

In some areas an amendment of the proposed text in the Directive and the Regulation is needed. Please find below our remarks and we would be happy to provide some more details if needed.

A risk based OC-requirement embracing specialized mortgage banks is needed
It is positive that the requirements in the regulation proposal (CRR) Article 3a gives the competent national authority the possibility to set the OC requirements from the actual risk weights on the assets i.e. a risk-based approach to an OC level not lower than 2 per cent (nominal requirement).

At the same time, issuers of covered bonds have to meet the continuous compliance with the LTV-limits in CRR Article 129, 1b and 1c. Following the inception of the mortgage loan into the cover pool, loan to value limits might be breached on an indexed basis by property price deflation.

Specialized mortgage banks are often non-deposit taking entities only allowed to grant mortgage loans funded by covered bonds. At the time of granting a mortgage loan, the outstanding debt is within the LTV-limits in CRR Article 129, 1b and 1c. The whole mortgage loan remains in the cover pool at all times until refinancing or redemption. This system is very transparent for investors ensuring that the mortgage lending in the cover pool is not substituted with other types of assets over time. Therefore, in case of breaching LTV-limits, these specialized mortgage banks have no possibility to restore the coverage requirements by substituting with other eligible mortgage loans into the cover pool.

Memo

May 16, 2018
Doc. no. 581988-v1

The fact, that the whole mortgage loan remains in the cover pool at all times despite potential breaching LTV-limits means that the specialized mortgage banks are obliged to apply other credit risk mitigation tools in form of

i. maintaining a full claim corresponding to the value of the loan regardless of the value of the property and not just up to defined limits of the property value[1],
ii. holding the borrower personal liable for whatever is not covered by a sale of the property, and
iii. all times transferring overcollateral in form of other eligible assets than mortgage loans (for instance government bonds) into the cover pool, reflecting the minimum capital requirements of the loans secured by immovable property[2].

The proposed OC-requirement appears to take into account only a part of the above mentioned credit risk mitigation tools. Thus, the OC requirement on top of substitution assets in form of other eligible assets than mortgage loans (for instance government bonds) replacing the part of the loans breaching the LTV-limits will inappropriately increase the liquidity risk for the specialized mortgage banks as they have to fund the eligible assets. At an unchanged level of capital these banks will have less capacity to add extra collateral to absorb falling prices on property.

---

[1] I.e. if a residential property value declines increasing LTV to 85 per cent the mortgage bank maintains a full claim on the loan and the property and not just up to 80 per cent of the property value
[2] I.e. increasing LTVs due to falling property prices results in increasing capital requirements thus extra overcollateral in the cover pool.

Thus, this interaction between requirements will not underpin financial stability, and it is not logical that any claim on collateral as real property above the LTV-limit has **no** value. The collateral still has a value which should be taken into account in the calculation of the coverage requirement (i.e. requirements for substitution assets and/or OC).

Derivatives
Covered bond issuers can reduce risk between loans and issued covered bonds in cover pools in different ways. One way is to use cover pools derivatives. The derivatives also make it possible to provide more product options and types for borrowers, while keeping the issued covered bonds standardized and hence making it possible to issue bond series with larger volumes which has become essential due to LCR issue size requirements. We therefore welcome the possibility in the directive Article 11 to use derivatives exclusively to mitigate risk.

Memo

May 16, 2018
Doc. no. 581988-v1

In order to facilitate a complete hedge risk and mismatches on both loans and on issued covered bonds, we suggest that no limit is set on the principal amount on derivatives contracts used for hedging in covered bond cover pools.

The derivative counterparty should rank pari passu with holders of covered bonds, and the derivative contracts are not terminated in case of issuers default. This means that the derivatives will also in a default situation be in place to hedge the risk between borrower payments and payments to holders of covered bonds. This ranking of the derivate counterparty has to be clarified in Article 4 in the proposal for a covered bonds directive.

If a derivative contract has a positive value for the covered bond cover pool, the counterparty must post variation margin to the cover pool. Margin can be posted in various eligible assets. However, it is market practice that collateral is posted either in the form of cash or in government bonds. We suggest that derivatives contribute to coverage (including OC requirement) by their market value, and that the exposure is either the counterparty or the posted collateral. That is, if the market value of the derivative is secured by cash or government bonds the exposure does not fall under the limits for exposures to credit institutions in CRR Article 129.

Eligible assets
The covered bonds legislation should underpin the very high quality of covered bonds compared to other types of funding. Our concerns are with the part of Article 6 which refers to "other high quality assets". It seems to be too broad and opens up for different interpretations. We would advise to reconsider it.

At the same time, from a financial stability point of view, the current two-tier eligibility structure, whereby one set of criteria defines a covered bond, and additional criteria defines a covered bond eligible for preferential treatment in CRR, should be maintained i.e. the definition should still leave room for covered bonds ineligible for preferential treatment. This structure is part of the proposal for a covered bonds framework and it is important to keep it.

Without a two-tier eligible structure, even AAA-rated covered bonds can lose their covered bond status entirely. This leaves investors with an uncertain regulatory treatment of the bonds and the risk of being short of capital and HQLA. Furthermore, and perhaps even worse, they are obliged to sell the bonds as they fall out of their investment mandates requiring covered bonds. This can be a potential threat to financial stability.

Requirements for coverage

The coverage requirements in Article 15 in the Directive are to us somewhat difficult to understand. Especially the understanding and the use of a nominal principle according to subparagraph 1(b).

Regarding the requirement in subparagraph 1(a) the central point is that the cash flow from the assets in the cover pool must cover the cash flow required on issued covered bonds. This could be calculated either as the nominal cash flow or the discounted value of cash flow on assets and issued covered bonds. This cash flow approach is essential for a covered bond program and should be mentioned in the directive. In addition, the value of the eligible assets in the cover pool must correspond to at least 100 per cent (for CRR-compliant covered bonds 102/105 per cent including OC) of the value of the issued covered bonds, calculated either at nominal or market value.

When calculating coverage, derivatives should not be included in the calculation by the nominal principal amounts as mentioned in the paragraph about derivatives.

Composition of cover pools

For investors, there is extensive disclosure on the composition of the cover pool and we find no need for any requirements on the composition of the cover pool in the directive. We would suggest the deletion of Article 10.

If a requirement on the composition will be part of the Directive, it should be possible to have residential and commercial real estate loans in the same cover pool. There has already been taken care of the different risk profiles by different LTV-limits and disclosure of the composition of the cover pool. Cover pools with both residential and commercial real estate loans are used today in a number of countries and help diversify the risk. Furthermore, this makes it possible to issue bond series with larger volumes which has become essential due to LCR issue size requirement.

Intragroup pooled covered bond structures

In the rules in Article 8 on intragroup pooled covered bonds structures a criteria is included saying that:

(d) both the internally and the externally issued covered bonds qualify for credit quality step 1 as referred to in Part Three, Title II, Chapter 2 of Regulation (EU) No 575/2013 and are collateralised by residential or commercial property mortgages.

As we see it setting a credit quality requirement on both the internally and externally covered bonds to be used would give an unwanted rating volatility which should be avoided. Also, we see no justification of why the use of intragroup joint funding should be limited to be used only for covered bonds qualifying for credit quality step 1. This requirement should be deleted.

Grandfathering

We find it positive that the grandfathering provisions in both the Directive and in the Regulation facilitates that covered bonds issued under the current legislative framework are still recognized as covered bonds after the new rules enter into force. At the same time, it is necessary with a smooth transition to the new requirements for issuers of covered bonds using tap-issuing covered bonds. A possible way to grant some flexibility would be to allow the use of open bonds series for issuance after the new rules have entered into force contingent of permission from the national competent authority. A smooth transition has to be seen in close connection with the LCR issue size requirements.

Issuers of covered bonds could also be interested in upgrading their covered bonds issued under current legislative to comply with the new rules in both the Directive and the Regulation. This could reduce the complexity. Such upgrading is only possible if the rules on grandfathering are made more flexible with an option to upgrade and not requiring all covered bonds to be grandfathered.

Technical comments

In the draft directive on covered bonds a clarification of the definition in Article 3 (13)"match funding requirement" is needed by after " …to be made to the covered bonds investors" to insert "taking payments under derivate contracts into account".

The draft Regulation (CRR) needs to be clarified:

In the new paragraph 1a (c) of Article 129 (and in preamble No 7) about the limit of 10 per cent and 15 per cent the second subparagraph refers to the fact that these limits are not applicable for covered bonds issued pursuant to Article 9 of the draft Covered Bond Directive. The reference, which is intended for "intragroup pooled covered bond structures", should rightfully be Article 8 both places (and not Article 9).

Memo

In the new paragraph 1b in Article 129, the reference to point (d)(i) should be extended to include point(e). There is no mention of the access of raising LTV to 70 per cent in the new paragraph 1c. There should also be a reference to this.

May 16, 2018
Doc. no. 581988-v1

The new paragraph 7 in Article 129 (grandfathering) in the draft Regulation needs also to take into account all covered bonds issued according to the current Article 129 (1) and (3) + the current Article 496 of the CRR (the MBS waiver).

We look forward to a continuing dialogue on the covered bond proposal.

Kind regards,

Ane Arnth Jensen
Deputy CEO of Finance Denmark
CEO of the Association of Danish Mortgage Banks