



**FINANCE
DENMARK**

To the European Commission

Response to the European Commission's Consultation on amending the LCR Delegated Regulation

Finance Denmark - representing the Danish issuers of covered bonds – one of the largest covered bonds jurisdictions globally – would like to thank the European Commission for the opportunity to respond to the consultation on amending the LCR Delegated Regulation to cater for covered bonds.

The proposal from the European Commission contains amendments to the LCR Delegated Act to:

- remove the overlap/double counting between the liquidity buffer in the Covered Bonds Directive (CBD) and the liquidity coverage requirement in the LCR Delegated Regulation and
- align with Article 129 of the CRR and CBD.

The proposal includes a significant narrowing by only letting CRR-compliant covered bonds being eligible as Level 1, Level 2A and Level 2B assets. This should be avoided. The reference in the existing LCR to covered bonds meeting the requirements set out in UCITS 52.4 should in Finance Denmark's opinion be replaced by reference to the CBD - however this seems not to be the case. The narrowing of eligible covered bonds is neither justified nor a prudent approach and will undermine the intention and the initial motivation of creating a European wide, harmonized Covered Bond definition for regulatory purposes.

In the proposal the European Commission recognises it as prudentially sound that liquidity risks related to net outflows in a covered bond program can be fully covered by HQLA encumbered in the cover pool when solving the double counting issue. Finance Denmark appreciates and supports a solution along this line provided that:

- It is ensured that in general encumbered HQLA in a cover pool can be deemed to be unencumbered in the LCR requirement up to the amount of net liquidity outflows (the LCR requirement) from the associated covered bond programmes – irrespective of the HQLA being part of the cover pool liquidity buffer or due to other regulatory coverage requirements. This means that deeming HQLA as unencumbered is not contingent on and capped by a cover pool liquidity buffer requirement.

November 24, 2020

Doc: FIDA-386887857-687804-v1

- It is explicitly stated that HQLA fulfilling other regulatory coverage requirements can also be included when deeming HQLA unencumbered up to the amount of net liquidity outflows stemming from the associated covered bond programme.

If the LCR net liquidity outflows stemming from the associated covered bond programme is larger than the CBD liquidity buffer requirement – and the access to deeming HQLA as unencumbered is contingent on the CBD liquidity buffer requirement - issuers will have an incentive to keep the HQLA covering cover pool liquidity risk outside the cover pool. We find this to be conflicting with the prudentially sound prospect of having the HQLA needed available in the cover pool.

Furthermore, it should be clarified that all 'non-mandatory overcollateralisation' in covered bond programmes (according to article 411 (1)(6) in CRR2) is considered unencumbered.

Finance Denmark has elaborated in detail in the attached annex and would be pleased to explain and discuss the details at an on-line meeting with the European Commission.

Kind regards,

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Annex

Reference to the CBD as replacement of UCITS' definition of covered bonds

In the current version of the LCR Delegated Regulation extremely high quality covered bonds can according to Article 10 (1) (f),(i) qualify as level 1 liquid assets if "they are bonds as referred to in Article 52(4) of Directive 2009/65/EC or meet the requirements to be eligible for the treatment set out in Article 129(4) or (5) of Regulation (EU) No 575/2013" and fulfil the other requirements in Article 10. In Article 11 (level 2a assets) and Article 12 (level 2b assets) in the current version of the LCR Delegated Regulation you find the same reference to covered bonds.

With the proposal for amending Article 10 (1)(f),(i), Article 11 (1)(c),(i) and Article 12(1)(e)(i) the reference to Article 52(4) in the UCITS has been left out/deleted. This is a significant narrowing of only CRR-compliant covered bonds being eligible as Level 1 assets, Level 2A and Level 2B. This is neither justified nor a prudent approach and should be avoided.

What should have been done from Finance Denmark's point of view is amending the reference to covered bonds meeting the requirements set out in UCITS 52,4 to a reference to the Covered Bond Directive (CBD) (amended text is highlighted in red).

Number 4 in the proposal – Article 10(1)(f) should be worded in this way:

"(i) **they are bonds as defined in point (1) of Article 3 of Directive (EU) 2019/2162 of the European Parliament and of the Council, or** they meet the requirements to be eligible for the treatment set out in Article 129(4) or (5) of Regulation (EU) No 575/2013, or they are issued before 8 July 2022 and meet the requirements set out in Article 52(4) of Directive 2009/65/EC, as applicable on the date of their issue, until their maturity;

Article 11 (1)(c),(i) and Article 12(1)(e),(i) should be worded in the same way.

Amending the reference in the existing LCR Delegated Regulation to covered bonds meeting the requirements set out in UCITS 52(4) to a reference to the CBD is in accordance with the amendments of the UCITS 52(4) reference for covered bonds in other EU regulation. We refer to Article 28 and 29 in CBD.

If covered bonds as defined in the CBD are not included in the LCR Delegated Regulation it will undermine the intention and the initial motivation of creating a European wide, harmonized Covered Bond definition for regulatory purposes.



LCR/CBD liquidity buffer overlap

HQLA to be deemed unencumbered

To avoid overlap of CBD liquidity buffer requirement and the LCR requirement the European Commission proposes the following new article 7 (2a) in the LCR-delegated regulation:

“2a. By way of derogation from paragraph 2, liquid assets that are held as part of the cover pool liquidity buffer shall be deemed to be unencumbered during the 30 calendar day stress period, laid down in Article 4, up to the amount of net liquidity outflows as calculated under Title III of this Regulation, which result from the associated covered bond programmes, provided that those assets meet all other requirements laid down in Title II of this Regulation.”

The European Commission recognises in the proposal that it is prudentially sound to cover liquidity risk in a cover pool with encumbered HQLA within the cover pool. The encumbrance secures that the liquidity to cover net cash outflows on issued covered bonds are also available in a default scenario and hence are not used to cover liquidity risk on payments outside of the covered bond programme.

Finance Denmark agrees with the European Commission if the Commission's proposal implies that encumbered HQLA in a cover pool due to the total coverage requirement (CBD art. 15 and 16, CRR art. 129(3a) (OC requirement) for CRR-compliant covered bonds) can be considered as unencumbered in LCR up to a maximum of the covered bond programme's contribution to the credit institution's total LCR requirement. It is our view that the LCR unencumbrance should not be conditioned on a specific CBD liquidity buffer requirement as a cap on the amount of HQLA that can be unencumbered in LCR.

The unencumbrance of HQLA in the LCR-buffer should only depend on the existence of a LCR requirement on the covered bond programme, and that this requirement constitutes the cap for the unencumbrance of HQLA in the LCR-buffer. This cap secures that encumbered HQLA cannot be used to cover LCR requirements outside the covered bond programme. I.e. the encumbered HQLA in cover pools cannot contribute to an LCR surplus in the total LCR-ratio for the financial institution.



If the proposal on the other hand implies that the LCR unencumbrance is under the condition of a CBD liquidity buffer requirement as a cap on the LCR unencumbrance the result is for covered bond issuers with an expected CBD liquidity buffer requirement close to 0 (due to match funding and statutory maturity extension structures) that the LCR net cash outflow in the cover pool must be covered by unencumbered HQLA. This unencumbered HQLA can be placed outside the cover pool and can hence be used to cover liquidity risk outside the cover pool in case of default. We find this to be conflicting with prudentially sound prospect of having the HQLA available in the cover pool.

This will have the unintended and inappropriate consequence that the CBD liquidity buffer requirement sets a cap for the HQLA unencumbrance for LCR purposes. Also what is considered "prudentially sound" is defined differently and inconsistent, i.e.:

- The LCR requirement can be fulfilled with HQLA encumbered in a cover pool if the CBD liquidity buffer requirement \geq LCR requirement > 0
- The LCR requirement cannot be fulfilled with HQLA encumbered in a cover pool if the CBD liquidity buffer requirement = 0

Another undesirable consequence could be, that the incentive to hedge liquidity risk in covered bond programs might be reduced as illustrated in the following example:

Example:

Time 0:

- Cover pool: 95 loans and 10 HQLA. All 105 encumbered to cover 100 covered bonds.
- Covered bond program's LCR requirement: 5 due to the 75% inflow cap (all inflows and outflows balance within next 30 days).
- CBD liquidity buffer requirement: 10 due to 10 covered bonds maturing in 45 days (all other flows balances within the next 180 days).

Time 1:

The refinancing risk in 45 days is eliminated by the issuance of 10 long term covered bonds and buying back and redeeming the 10 short term (45 days) covered bonds. The result is:

- Cover pool: 95 loans and 10 HQLA. All 105 encumbered to cover 100 covered bonds.



- Covered bond program's LCR requirement: 5 due to the 75% inflow cap (all inflows and outflows balance within next 30 days).
- CBD liquidity buffer requirement: 0 after refinancing (all other flows balances within the next 180 days).

The liquidity/refinancing risk is eliminated, but 5 of the 10 HQLA in the cover pool is no longer deemed unencumbered. This implies that the LCR requirement must be met by another 5 unencumbered HQLA outside the cover pool since the 10 HQLA in the cover pool is encumbered to comply with the coverage requirement in the cover pool. This is an unintended consequence, as it removes the incentive to hedge the refinancing risk in a prudent manner. The liquidity requirement is increased although the liquidity risk has been reduced.

It should be possible to fulfil the LCR requirement with HQLA encumbered in cover pools regardless of the level of the CBD liquidity buffer requirement. Also this will secure a level playing field between business models that only have encumbered HQLA due to the CBD liquidity buffer requirement (e.g. a universal bank) and business models that have encumbered HQLA due to general coverage requirements (i.e. special bank models, like the Danish mortgage system.)

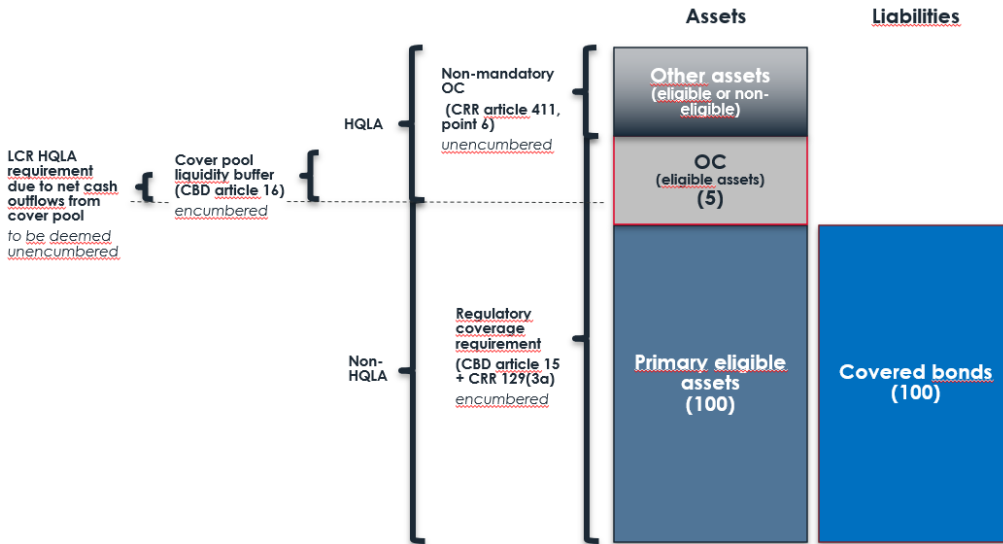
Examples of compositions of cover pool

Different possible levels of CBD coverage requirement, CBD liquidity buffer requirement and LCR requirements from a covered bond programme are illustrated in the following five examples of cover pool compositions. Example 1 is the baseline and example 2-5 are variations of the baseline.

In these cases, encumbered HQLA are recognized as fully capable of covering LCR requirements in the covered bond programme – except example 5 where the CBD liquidity buffer requirement is less than the LCR-requirement from the covered bond programme. In this case, none or only a part of the encumbered HQLA in the cover pool are recognized to cover LCR requirements in the covered bond programme.

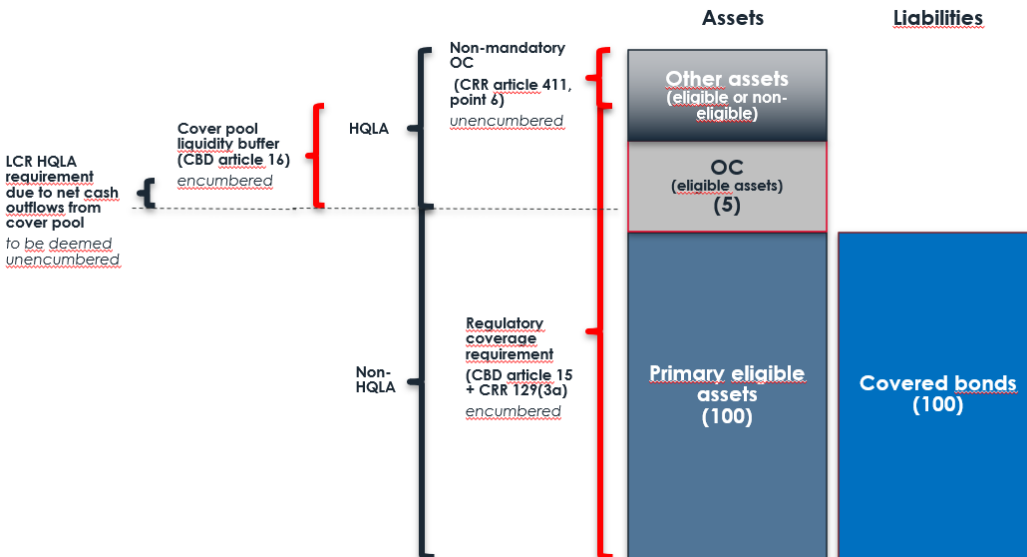


Example 1 - Baseline



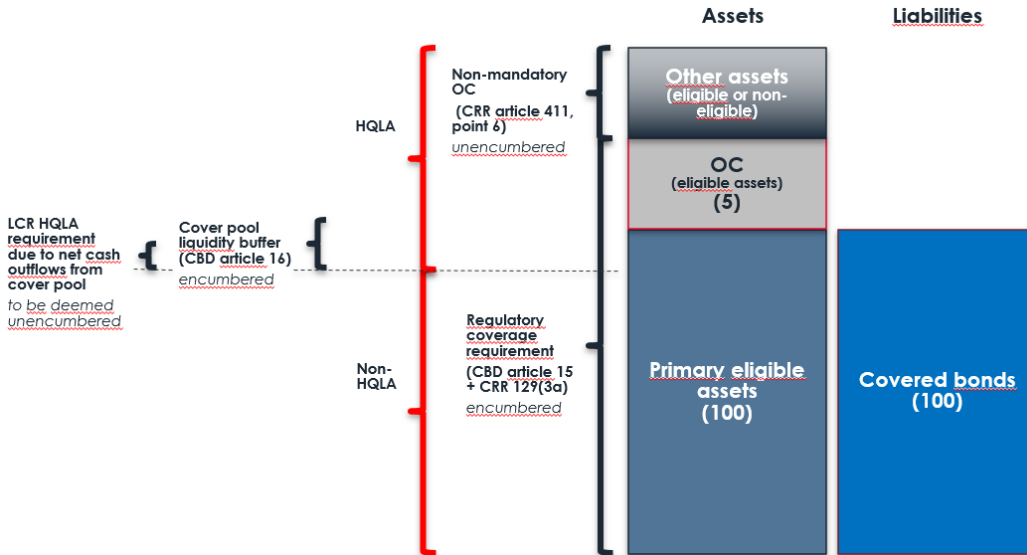
Example 2

Possible situation where 'primary eligible assets' + OC do not contain enough HQLA.



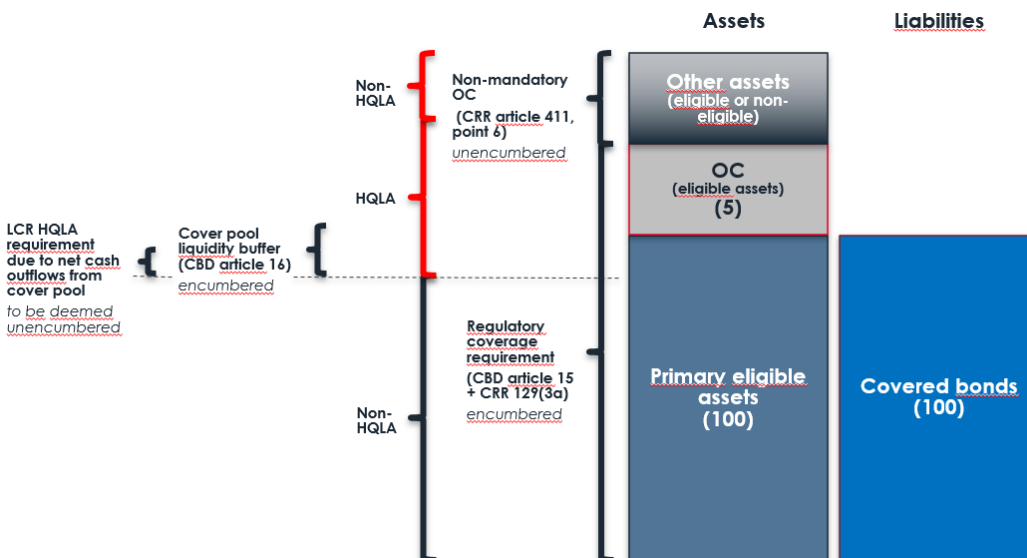
Example 3

Possible situation where part of 'primary eligible assets' are HQLA.



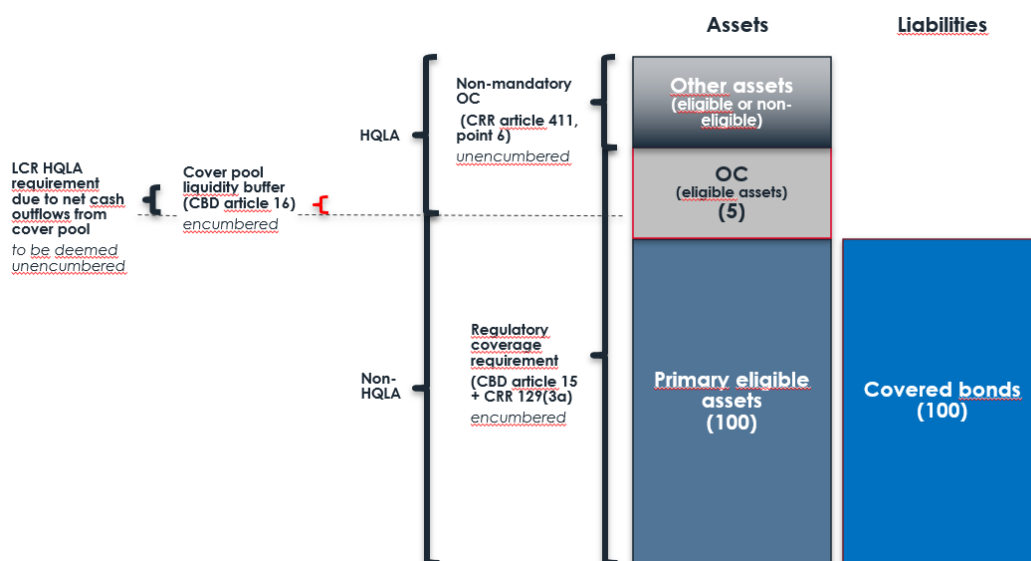
Example 4

Possible situation where part of 'other assets' are non-HQLA.



Example 5

Possible situation where paragraph 5 and/or 6 in CBD article 16 is applied.



To avoid this inconsistency and to create a level playing field for all business models and cover pool compositions we propose the following adjustment of the proposal (amended text is highlighted in red):

“(2) Article 7 is amended as follows:

2a. *By way of derogation from paragraph 2* liquid assets that are held as part of the cover pool liquidity buffer *or due to other regulatory coverage requirements* shall be deemed to be unencumbered during the 30 calendar day stress period, laid down in Article 4, up to the amount of net liquidity outflows as calculated under Title III of this Regulation, which result from the associated covered bond programmes, provided that those assets meet all other requirements laid down in Title II of this Regulation.”

“(3) in Article 8(4), the following third subparagraph is added:

“For liquid assets held in a cover pool liquidity buffer *or due to other regulatory coverage requirements*, the requirement laid down in the first subparagraph shall be considered as fulfilled, where the credit institution regularly, and at least once a year, monetises liquid assets that constitute a sufficiently representative sample of its holdings of assets in the cover pool liquidity buffer without having to be part of that buffer.”;



Point (2) in recital:

*“(2) The general liquidity coverage requirement laid down in Article 4(1) of Delegated Regulation (EU) 2015/61 and the cover pool liquidity buffer requirement laid down in Article 16 of Directive (EU) 2019/2162 result in an obligation for credit institutions issuing covered bonds to hold a certain amount of liquid assets for the same period of 30 calendar days. However, credit institutions should not have an obligation to cover the same outflows with different liquid assets for the same period. To address that overlap, the encumbrance criterion under the general liquidity coverage requirement should be adapted to treat liquid assets held as part of the cover pool liquidity buffer **or due to other regulatory coverage requirements** as unencumbered up to the amount of net liquidity outflows stemming from the associated covered bond programme”.*

Clarification of non-mandatory OC unencumbrance

Finance Denmark would suggest that it should be clarified that all liquid assets in the covered bond programme not constituting part of the coverage requirements, i.e. non-mandatory overcollateralization as defined in CRR article 411, point (6), is classified as unencumbered and available to cover outflows from any part of the credit institution. This to be in line with the NSFR rules according to Article 428p (6) (c) in CRR2.

A new point (c) is inserted in Article 7 after paragraph 2(b):

*“(c) **assets attached as non-mandatory overcollateralisation in covered bond programmes as defined in point (6) of article 411 of [CRR].***

In point (2) in the recital it should be added that:

*“**Also it should be clarified that all liquid assets in the covered bond programme not constituting part of the coverage requirements, i.e. non-mandatory overcollateralization as defined in [CRR] article 411, point (6), is classified as unencumbered and available to cover outflows from any part of the credit institution.**”*

