Members of the ECON Committee *24.9.2018*

Comments to EP draft report on the Covered Bond proposal

Finance Finland, Finance Norway and ASCB (Association of Swedish Covered Bond issuers) together support the EU harmonisation efforts on covered bonds but are wary of hampering well-functioning and cost-efficient markets.

Covered bond funding is especially important for Nordic countries. The total covered bonds outstanding at the end of 2017 stood at EUR 219 billion in Sweden, EUR 115 billion in Norway and EUR 35 billion in Finland. This together constitutes 15 % of the total outstanding covered bond stock globally and 16 % in Europe.

Covered bonds have proved to be a stable funding source with historically low loss ratios in the underlying assets, even during financial stress. We support the EU co-legislators aim to enhance the use of covered bonds as a stable and cost-effective source of funding for credit institutions. We would like to particularly highlight the importance of cost-effectiveness.

In Nordic countries, small banks also issue covered bonds. Thus, it is especially important not to increase the fixed costs for issuers to allow for smaller issuers in the market as well. We believe there are certain risks in the proposal which might hamper the well-functioning and cost-efficient markets of today. These concerns are highlighted in the specific comments to articles below.

1. Article 16, Requirement for a cover pool liquidity buffer

The proposed article 16 of the Directive sets the requirements for a cover pool liquidity buffer. The cover pool liquidity buffer shall cover the net liquidity outflow for 180 calendar days.

We find the buffer requirements excessive and with a preference tilted toward current liquidity management structures jurisdictions, considering elements already in place in other regulation. Firstly, issuers are already subject to strict LCR liquidity buffer requirements, which are calibrated for stressed conditions. Secondly, in the revisions to CRR (CRR2) proposal for net stable funding ratio (NSFR), covered bonds with remaining maturity of less than 6 months will not constitute any available stable funding. Banks need to cover the shortfall with other forms of stable funding.

In addition to the above-mentioned EU liquidity regulation there are other tools in Nordic legislation to address liquidity risk.

The additional liquidity buffer requirement at the cover pool level would increase the funding costs substantially. It could be devastating especially for small issuers. This would without doubt make the use of covered bonds as a funding source less attractive as the cost difference would decrease, and as a result other less stable funding sources would be used instead thus negatively impacting the supply and liquidity of established covered bonds markets contrary to the aim of the directive.

Recommendation: In order to maintain national flexibility to handle liquidity risks in the most efficient manner, we propose to keep Commission wording for Art 16 (4) and not to delete it as the Rapporteur proposes. Member States must be allowed to decide that the 180-day liquidity buffer should not apply if the issuer is subject to other appropriate liquidity requirements in other acts of Union or national laws in line with recital 21. For Art 16 (5) we propose to keep Commission text as it is.

There is also an issue with liquid assets in the cover pool being perceived as encumbered and hence not eligible for use in fulfilling the LCR requirement. We propose to amend article 16 so that liquid assets in the cover pool liquidity buffer are considered unencumbered when calculating liquidity requirements (LCR) specifically in relation to covered bond related cash flows. Alternatively, we propose that member states should be required to ensure that different liquidity requirements (i.e. not limits to the 180 days buffer) in Union law is coordinated in a way that avoids double requirements.[1]

2. Article 17, extendable maturity structures

The proposed article 17 of the Directive includes conditions for extendable maturity structures. The Rapporteur suggests amendments in Article 17 so that the maturity extension may only be used in the event of insolvency or resolution and the trigger should be established by national law and approved by the competent European authority.

Roughly half of the covered bonds issued in Finland include soft bullets and in Norway nearly 90 percent. Therefore, article 17 and its final content is very important especially to Finnish and Norwegian issuers. Maturity extension is an important and cost-efficient tool for issuers to manage liquidity and re-funding risks and the use of these structures should not be penalized.

The advantage of the maturity extension from the perspective of both investors and issuers is to avoid resolution or insolvency of the issuer. It is particularly useful when the bank is under severe stress but not yet in default. The investors have full transparency of these structures, since maturity extension triggers are specified in contracts as stated in Art 17 par 1 (a), which preserves investor protection. Therefore, maturity extension structures should be allowed in *going concern* and not only *gone concern* basis.

Recommendation: We propose to define maturity extension triggers in such a manner which allows them to be used both in *going* and *gone concern* basis in line with practice in well functional markets and which clearly defines situations where extension would be triggered.

3. Article 11, Derivative contracts in the cover pool

In article 11 (2)(b), the directive introduces a limit on the amount of derivative con-tracts in the cover pool. It is unclear if the term amount means pertains to an absolute e.g. a EUR/other currency limit, which would be harmful and counterproductive.

[1] The possibility of double liquidity requirements was also raised as a concern in the EBA report on covered bonds from 2016. Also note that the topic has been commented by the Basel Committee on Banking Supervision in the second set of frequently asked questions (FAQs) on the LCR framework (June 2017). Their answer on question 16 states an alternative solution which enables amounts in the pool that will become unencumbered in the next 30 days to be considered as inflows.

Derivatives are only allowed for hedging purposes, there is no need for a limitation. On the contrary, a limit may actually increase the risks in covered bond structures. If the derivative limit is reached and there is no possibility to further hedge risks, currency and interest risks rise as a result.

Recommendation:

Art. 11 par. 2(b) should be amended as:

~~(b) the limits on the amount of derivative contracts in the cover pool;~~

4. Article 6 a, Eligible assets

EP Rapporteur proposes two layers of CBs, “premium” and “ordinary”. He also proposes new article 6a for "ordinary covered bonds".

We fear that broadening the scope of eligible assets too much will dilute the CB product and have negative effects on the market. The use of other instruments such as the ESN for other types of assets would take this into account in a better way.

Recommendation: Delete article 6a

5. Article 15. Requirements for coverage

EP Rapporteur has proposed to delete Art. 15 1. (c) point (iv). This implies that the value of the derivative contracts cannot contribute to the coverage requirement.

Derivative contracts are entered into to fulfil risk hedging requirements and if included in the cover pool should contribute to a more stable coverage calculation (given for instance the counteracting effects from derivatives on fx-movements on the liability side). Derivative contracts are not entered into with the sole intention of fulfilling coverage requirements.

The proposed amendment may have a large negative impact for an issuer that has its cover pool assets in a different currency than its covered bonds. By not allowing for derivatives to contribute to the coverage, issuers could, in case of an adverse fx-rate movement, breach the coverage requirement. This could, effectively, lead to issuers being excluded from issuing covered bonds in a currency that differs from the denomination of its cover pool assets. This is unacceptable. Hence, derivative contracts that fulfil the requirements in Article 11 should be included in the cover pool and contribute to the coverage.

Note that the above issue also stems from the term "nominal amount" not being defined in the directive. If the nominal amount in the coverage requirement calculation takes the derivatives into account when determining the liability value of the covered bonds, then this may also address the above issue.

Recommendation: Keep the Commission text for Art. 15 1. (c) point (iv)

6. Article 1(1) a) iii) in the Regulation, proposing amendments to CRR art 129

It has become increasingly difficult to find credit institutions with credit quality step 1. There are already relatively strict limits for exposures towards credit institutions with lower credit quality, and further limiting the possibility to get approval for such exposures would cause problems for covered bond issuers. There is consequently a significant risk of concentration problems, particularly in smaller currency areas, if exposures were to be confined to credit institutions meeting credit quality step 1.

Only allowing credit quality step 1 on derivative exposures creates unwanted cliff effect risks for issuers related swap counterparty rating downgrades and sensitivities towards potential rating methodology changes that could change the rating landscape.

Recommendation: Keep the Commission text which allows credit quality step 2 as well.

Finance Finland

Finance Norway

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