Comments

on proposed Directive on the issue of covered bonds and covered bond public supervision & proposed Regulation on amending Regulation (EU) 575/2013 as regards exposures in the form of covered bonds

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The **German Banking Industry Committee** is the joint committee operated by the central associations of the German banking industry. These associations are the Bundesverband der Deutschen Volksbanken und Raiffeisenbanken (BVR), for the cooperative banks, the Bundesverband deutscher Banken (BdB), for the private commercial banks, the Bundesverband Öffentlicher Banken Deutschlands (VÖB), for the public-sector banks, the Deutscher Sparkassen- und Giroverband (DSGV), for the savings banks finance group, and the Verband deutscher Pfandbriefbanken (vdp), for the Pfandbrief banks. Collectively, they represent more than 1,700 banks.

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The German Banking Industry Committee (GBIC/DK) is pleased to participate in the EU-Commission's public consultation on a proposal on a Directive on the issue of covered bonds and covered bond public supervision & on a proposal for a Regulation on amending Regulation (EU) 575/2013 as regards exposures in the form of covered bonds.

The Directive proposal is built on principles based rules in line with the expectations of GBIC. It provides minimum harmonisation inspired by well-functioning and mature national markets. At the same time, the rules offer sufficient room for national specificities.

We specifically welcome the consistency of the proposed supervisory regime with a focus on covered bond public supervision and investor protection. Overall, the approach covers in our view all necessary elements for a sound covered bond product, thus achieving the objective of justifying a preferential treatment in terms of capital requirements. However, the proposal reveals some uncertainties regarding its scope (eligibility of cover assets) and the composition of cover pools.

We also welcome the proposed amendments of Article 129 CRR aiming at reinforcing and complementing the requirements for the preferential capital treatment of covered bonds.

I. Draft Covered Bond Directive

Recital 26

The definition of a covered bond programme vs. single issuances is misleading, because the wording "not necessarily" provides the impression that normally a special cover pool for every ISIN would be required.

Definitions (Article 3)

As regards par. 3, the requirement that cover pool assets 'are' segregated from the other assets is confusing as in many Member States this segregation does not occur during the going concern of the credit institution, but only at the moment of the opening of an insolvency proceedings of the issuer (see Art. 12). As a going concern, cover pools are not segregated from the other assets.

Eligible Assets (Article 6)

We note that cover assets must be of high quality. While the referenced Article 129 (1) CRR provides some indication for the required quality level, the proposal does not really provide qualitative criteria allowing Member States to set more precise parameters. Instead, the proposal only provides formal criteria (valuation, legal certainty and enforceability) which don't seem robust enough. We conceive the missing specification of the 'high quality' requirement as a qualitative uncertainty of the proposal.

We therefore advise to replace or complement the 'high quality' criteria by a precise list of tangible assets suitable to cover a longer life-cycle matching the long term maturities of the outstanding covered bonds.

Concerns about the extent of eligible assets are also valid in our view when it comes to the listed collateral types. Charges, liens and/or other guarantees open certain room for interpretation and innovative structures potentially leading to a wider range of eligible assets than those traditionally accepted. In turn, this could translate in weaker capital market performances of the respective covered bond product. It could then also be more difficult to differentiate eligible cover assets under this Directive from those under a potential ESN proposal.

Furthermore, in the first paragraph of Article 6, it is important to clarify that the listed requirements under a) to d) only apply to the 'other assets' which might be considered by Member States of high quality.

Finally, we also note an unspecified use of the term 'asset'. Cover assets consist of exposures and not of the attached security tools. As mortgages, charges, liens or guarantees represent the collateral for the cover assets, all requirements such as enforceability, legal quality and valuation rules should refer to the

collateral and not to the cover assets. As an example, market or mortgage lending values refer to the assets. But as it is about valuation of properties, it should refer to the collateral and not to the assets. Similarly, Member States should lay down rules on valuation of the collateral (properties) instead of assets. The same applies to the enforceability requirement which must refer to the collateral and not to the cover asset.

Assets located outside of the Union (Article 7)

In the 2nd par., it is important to clarify that the legal enforceability requirement refers to the assessment of the equivalence of pledges and/or real estate collateral.

Intragroup pooled covered bond structures (Article 8)

It is unclear whether the pooling within groups is also admitted on a cross-border level. We would welcome rules allowing cross-border intragroup poolings by adding a specific clarification to Article 8.

Lit. (b) should not be restricted to a 'claim' on the issuing institution, but also allow for a purchase of covered bonds as an option to create pooled covered bond structures within a group.

Lit. (d) is missing public sector lending. We don't see a reason for restricting pooled structures to real estate lending only. Hence, public sector lending should be added to lit. (d).

Joint Funding (Article 9)

We question the need for Article 9 because rules regulating the transfer of loans exist in civil law in all Member States (assignment of claims) and the use of transferred loans by credit institutions appears common practice in financial services. As regards the terminology used, the term 'issued' in the second paragraph should be replaced by 'granted' to be in line with the wording of paragraph 1.

We also question why joint funding models are not available for loans to the public sector?

Composition of cover pools (Article 10)

We challenge the need for rules addressing the composition of cover pools and therefore propose the deletion of Article 10. There is no evidence that the composition of cover pools raises major concerns in capital markets and/or from investors. Full transparency of cover pools is provided. What is not dysfunctional should not be regulated.

Should this Article nevertheless be maintained, it shall be made clear that the sufficient level of homogeneity refers to the primary assets in order to draw the dividing line between primary assets and substitution assets. We presume that residential and commercial mortgage loans are both eligible for the same cover pool (mortgage cover pool).

Article 10 could also reveal as an obstacle to cross-border lending as real estate markets differ from country to country. Hence, cover pools composed by mortgage loans from several Member States could be considered as not having a homogenous risk profile.

Finally, we strongly oppose copying possible future homogeneity criteria defined by EBA for STS securitisation purposes to the composition of cover pools.

Derivative contracts in the cover pool (Article 11)

In par. 2 (c), we see the need clarifying to whom the necessary documentation must be provided.

Segregation of assets in the cover pool (Article 12)

Under paragraph 2, the stipulation of a mandatory asset segregation mechanism would be inconsistent if the issuing institution went into resolution and the applied resolution tool achieved the continuation of the institution as a going concern. We therefore recommend adding at the end of par. 2 the restriction 'depending on the applied resolution tool'.

We also recommend clarifying that the segregation of assets does not have to occur before the insolvency of the issuing institution. We conclude from the requirement 'shall also apply' read together with the cover pool definition of Article 3 par. 3 (assets 'are' segregated) that the asset segregation must exist at all times, i.e. also during the going concern of the issuing institution. Hence, we recommend replacing the terms 'are segregated' by "will be segregated in the moment of default".

In order to increase legal certainty in this context, we advise complementing this paragraph by recommending Member States earmarking the cover assets through their registration in cover asset registers.

We further suggest clarifying that the registration in a cover register fulfills the criteria "segregation" and "separation", if national CB law stipulates that the registered cover assets would be part of the specially treated cover pool, reserved for the CB investors. More generally, we question the difference between "segregation" and "separation"; the use of different terms could initiate interpretation where a difference is not aimed at.

Cover pool monitor (Article 13) and Recital 17

We very much welcome the separation between cover pool monitoring and public supervision. Consequently, it is our understanding that cover pool monitoring cannot be allocated to the public supervision, i.e. a cover pool monitor's activities would not discharge public supervisors from their duties (see Art. 18).

Investor information (Article 14)

Under Article 14, par. 2(c), risk details in relation to credit should be drafted in a more precise way. It obviously refers to loan-to-value risk. Hence, we recommend replacing 'credit' by 'LTV'.

Requirements for coverage (Article 15)

We would like to raise three aspects:

Operational costs: there is uncertainty about the classification of costs as operational costs. In addition, we would appreciate a clarification that the legally required over-collateralisation automatically covers operational costs. Lastly, we doubt that operational costs can in advance be determined numerically. The indication of a lump sum should be allowed by national law.

Accrued interests: We would appreciate a clarification that interest coverage can also be achieved through a net present value calculation and coverage requirement.

Defaulted uncollateralised claims: The wording in par. 1(d) stipulates that any minor default, even induced by technical error, would have as consequence that the entire cover assets have to be deleted from the cover pool. This would be disproportional. We therefore advise to delete par. 1(d) and to shift its content to the transparency requirements in Art. 14.

Cover pool liquidity buffer (Article 16)

Under Article 16 par 3 (b), in order to avoid concentration risks, exposures to institutions should be extended from credit quality step 1 institutions to institutions that qualify for credit quality step 2 in accordance with Article 129 CRR.

Extendable maturity structures (Article 17)

In order to reduce uncertainty, we see the need to provide a definition of the maturity extension triggers or at least of their underlying parameters. It must be ensured that the exclusion of discretionary powers is confined to the period before the insolvency of the bank. After the insolvency of the issuing institution, discretionary powers of a special administrator will be necessary. Member States should therefore be allowed to stipulate discretionary powers after the opening of the insolvency proceedings and such information should be provided under Article 17 par. 1 lit. (c)(ii).

Article 17 par. 1 lit (e) raises an interpretation issue of the term 'ranking'. Does this term refer to the ranking of covered bonds in the insolvency proceedings or to the order of the payouts of the covered bond creditors? We presume that it refers to the ranking in the insolvency because it is not excluded that the sequencing of payouts to creditors might be modified after the opening of the insolvency proceedings.

We note the obligation to notify covered bonds with extendable maturity structures to EBA (Article 17 par. 2) and would welcome a duty for EBA to disclose these notifications to the market.

Covered bond public supervision (Article 18 seqq.) and Recital 17

We welcome the robust provisions addressing the covered bond public supervision, especially the requirements defined by Article 18 par. 6.

We furthermore welcome the provision of Article 19 par. 1 conferring the power to grant a covered bond permission to the national competent authority.

Regarding the powers of competent authorities, Article 22 par. 2(c), the conduct of on-site and off-site inspections is not supposed to be a mandatory obligation for supervisors. We therefore recommend replacing the term 'power' by 'duty'.

Labelling (Article 27)

We recommend introducing a Label which reflects the difference between CRR compliant covered bonds (step 1) and Directive compliant covered bonds (step 2). Basically, a European Covered Bond Label should only be awarded to step 1 CRR compliant covered bonds. Labelling step 2 covered bonds without differentiating further would leave the prime standard without a mark of excellence and overestimate a common denominator which is – with respect to its large variety of eligible cover assets – to be classified at a lower quality level.

II. Article 129 CRR

We agree in general with all proposed amendments.

We, however, propose to clarify in Art. 129 paragraph 1 that derivatives do not fall under exposures to credit institutions according to Art. 129 subparagraph 1 (c). The purpose of derivatives in the cover pool is protection against interest rate and/or currency risk rather than collateralizing covered bonds. This nature of derivatives is highlighted by Art. 11 of the proposed covered bond Directive stating that "derivative contracts are included in the cover pool exclusively for risk hedging purposes". The intended protection of investors would be at risk, if derivatives were to be included in Art. 129 subparagraph 1 (c) and thus fell under the limits according to the new paragraph 1a.

As regards the new provisions on over-collateralisation, we note that public sector lending is not mentioned by the new par. 3a (a). We therefore assume that the assigned low risk weights to public sector loans allow for a level of over-collateralisation of 2% as is the case for residential mortgage lending.

Moreover, it would be more appropriate to assign the competence to decide on lower minimum levels of overcollateralization to Member States instead of competent authorities. Hence, 'competent authorities' designated pursuant to Article 18(2) of the draft Covered Bond Directive should be replaced by 'Member States'.

For covered bonds,

- issued before 31 December 2007, the new provisions of Art. 129 (1), (3), (3a) and (3b) CRR are not to apply,
- issued after 31 December 2007 but before the entry into force of the amending Regulation, the new provisions of Art. 129 (3a) and (3b) CRR shall not apply, i.e. paragraphs 1 and 3 CRR shall apply.

We have doubts whether for covered bonds issued before 31 December 2007 the provisions of the newly added paragraphs 1a, 1b and 1c CRR of Article 129 are indeed excluded from application to held assets. Furthermore, we cannot understand why covered bonds issued after 31 December 2007 but before the entry into force of the amending Regulation should be granted a less generous grandfathering. We therefore request clarification that all covered bonds being treated in a preferential manner prior to the entry into force of the amending Regulation may continue to benefit from the privileged regulatory treatment under Art. 129 CRR.

Furthermore, it must be feared that the grandfathering does not extend to EEA issuers. Pursuant to Article 129 paragraph 7 CRR, privileged covered bonds must meet the requirements of Article 129 paragraphs 1 and 3 of the amended CRR. This could be understood in such a way that only covered bonds issued by EU credit institutions (see Article 2 of the new Covered Bonds Directive) are allowed for the privileged treatment of held assets issued since 2007. In this respect, we also ask for clarification that the regulations apply to all EEA issuers.

Possible drafting errors:

In the Explanatory Memorandum, under section 5 'Other Elements', we note the paragraph on overcollateralization probably not in line with the legal text: "This level is set at 2 and 5% depending on the assets in the cover pool …. "

Recital 7 refers to Article 9 of the draft Covered Bond Directive for the regulation of intragroup pooled structures, although the draft Directive regulates these structures in Article 8.

The draft Regulation proposes to amend point (iii) of point (h) of Article 428 (l) CRR. However, point (h) of Article 428 (l) seems not to exist.