REGERINGSKANSLIET

Ministry of Finance

Ministry of Finance	Finansinspektionen	Sveriges Riksbank
Financial Markets Department	Banking	Financial Stability Department
Dnr: Fi2015/05714/B	Dnr: 15-15011	Dnr: 2015-00869

European Commission

DG Financial Stability

Financial Services and Capital Markets Union

The Swedish Government's and the Swedish Authorities' joint response to the Consultation Document of the European Commission: "Covered Bonds in the European Union"

Stockholm, 23 December 2015

Ministry of Finance **Finansinspektionen** **Sveriges Riksbank**

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Introduction

The Swedish Ministry of Finance, Finansinspektionen (the Swedish Financial Supervisory Authority), and Sveriges Riksbank welcome the possibility to comment on and present a shared view on the European Commission's consultation "Covered Bonds in the European Union". Comments and answers to particular questions are provided with reference to the enumeration of the particular question in the consultation. If a question or topic has not been commented on or answered, that should not be taken to constitute our approval or dismissal and we would like to reserve the right to comment on these questions at a later point in time. The term 'we', when used herein should be considered as the common view of the Ministry of Finance, Finansinspektionen, and Sveriges Riksbank.

Executive Summary

We welcome a discussion about the future of European covered bond markets and are supportive of initiatives aiming at ensuring more efficient, transparent and robust covered bond markets. At the same time, given the importance of covered bond markets as a reliable funding source for many European banks, including Swedish banks, it will be important not to jeopardise the function of the national regimes that already work well. To strike this balance we believe that the best way forward is through indirect, voluntary, non-legislative coordination measures based on high standards and best practices of the member states.

On the alternative option, i.e. a complete harmonisation of national laws or the provision of a new framework, we have more concerns than we see benefits. The legal frameworks and supervisory practices regarding covered bonds differ between member states for historical and market-specific reasons. We are concerned that a complete EU harmonisation of existing national laws relevant to covered bonds could conflict with other existing national legislations. One such conflict could occur in relation to national insolvency and resolution legislation, as these differ across member states. A complete EU harmonisation of laws related to covered bonds could therefore lead to different end-results in different jurisdictions.

Furthermore, and given the importance of these markets, a top priority will be to ensure that covered bonds remain a safe investment alternative. It will therefore be of utmost importance that the target actions do not erode investor confidence in covered bonds. We are concerned that an attempt to harmonising existing national legislation or to agreeing on a new framework would result in a weakening of some of the frameworks that already work well. Against this background we believe that a certain degree of national flexibility is necessary and that a complete legislative harmonisation would create undue problems.

The areas where we see potential for improvements and where targeted recommendations could be helpful include the content of the cover pool and potentially some transparency aspects.

As for the content of the pool, since the idea is to decrease fragmentation we believe it will be important to limit the types of assets qualifying as collateral for the cover pool. Unless the underlying assets are fairly homogeneous across markets, it will be hard to improve comparability and the whole idea of increased financial market integration risk failing. Covered bonds with underlying collateral in SME-loans, aircraft and shipping are both different in nature and more heterogeneous compared to for example mortgages or public sector claims. Introducing covered bonds with such assets would therefore render the chances of reducing fragmentation and facilitating increased cross-border investment flows. As such we believe that the cover pools should be restricted to residential, commercial, and public sector loans. Such restriction would also protect the robustness and reputation of covered bonds.

Finally, on transparency we see merits in awaiting the ongoing initiative, the so called harmonised transparency template (HTT), led by ECBC on transparency regarding covered bonds and their cover pools. By the start of 2017, HTT should be fully operational. Once in place, supervisors could assess its merits and evaluate if further recommendations are warranted.

In conclusion, we support option 1 in the consultation document i.e. indirect harmonisation through, for the member state, voluntary, non-legislative coordination measures such as targeted recommendations from the Commission.

LEGAL FRAMEWORK AND INTEGRATION

Q1: Would a more integrated ”EU covered bond framework” based on sound principles and best market practices be able to deliver the benefits suggested in section 2 of Part II? Are there any advantages or disadvantages to this initiative other than those described in section 2 of Part II?

We welcome initiatives that make the covered bond market more efficient, transparent and robust and believe that the best way to accomplish that is through indirect, voluntary, non-legislative coordination measures based on high standards and best practices of the member states.

Standardisation and increased transparency of financial products is generally beneficial for the functioning of markets and can contribute to making products more attractive for investors. Hence, a more integrated EU covered bond framework that implies more standardisation, transparency and comparability is likely to contribute to the benefits suggested in section 2 of Part II. At the same time, the covered bond market, where the underlying collateral is primarily residential mortgages and public sector claims, has typically proven to be an important and reliable funding source for many European banks including Swedish banks. Disruptions in this market may thus have a negative effect on financial stability. For this reason any form of weakening of frameworks that worked well during the financial crisis must be avoided. Against this background we believe that national flexibility is necessary and therefore that a legislative approach which implies maximum harmonisation should be avoided.

Also, since the purpose is to decrease fragmentation we believe in any type of coordination measure, it is important to limit the types of assets qualifying as collateral for the cover pool. Unless the underlying assets are fairly homogeneous across markets, it will be hard to improve comparability, and the whole idea of increased financial market integration runs the risk of failing. Covered bonds with underlying collateral in SME-loans, aircraft and shipping are both different in nature and more heterogeneous compared to for example mortgages or public sector claims. Covered bonds with such assets would therefore render the chances of reducing fragmentation and facilitating increased cross-border investment flows. As such we believe that the cover pools should be restricted to residential, commercial, and public sector loans. Such restriction would also protect the robustness and reputation of covered bonds.

Q2: In your view, are market-led initiatives such as the "Covered Bond Label" sufficient to better integrate covered bond markets? Should they be complemented with legislative measures at Union or Member State level?

The "Covered Bond Label" initiative is a means to set minimum criteria for what constitutes a covered bond and is, as such, a step in the right direction. Nevertheless, those criteria are quite imprecise. Hence, as there are limitations in how far the issuers can go concerning the integration of covered bond markets, especially when it comes to making their respective issuances comparable, some Union level measures could be warranted so as to improve efficiency, transparency and comparability of covered bond markets. However, we believe that the best way to accomplish that is through indirect, voluntary, non-legislative coordination measures based on high standards and best practices of the member states.

Complete legislative harmonisation could impose risks to today's well-functioning covered bond markets which could have implications for the financial stability. Further, a complete EU harmonisation of all rules relevant to covered bonds could also conflict with existing national legislations in other fields, creating ambiguities in legislation. As a result, harmonisation of covered bonds may in practice lead to different end-results in different jurisdictions. Therefore, any coordination measures must be based on the national frameworks that worked well during the financial crisis and must not lead to a watering-down of covered bond frameworks. The regulation should not undermine the low risk aspect of existing covered bonds.

Q3: Should the Commission pursue a policy of further legal/regulatory convergence in relation to covered bonds as a means to enhance standards and promote market integration? If so, which of the options suggested in section 3 of Part II should the Commission follow to that end and why?

An EU harmonised covered bond framework is unlikely to remedy fragmentation originating from e.g. credit risk which stems from the quality of the issuer and the assets included in the cover pool. We are of the opinion that the current shortcomings within the European Union as regards transparency and comparability can be improved by setting recommendations to Member States regarding minimum criteria for what is a covered bond. But it should not imply that investors are less responsible for conducting proper due diligence before buying covered bonds.

In our view, a complete EU harmonisation is not warranted. Legal frameworks and supervisory practices regarding covered bonds differ between member states for historical and market-specific reasons. A complete EU harmonisation of all rules relevant to covered bonds could in certain cases conflict with existing national legislations in other fields, creating ambiguities in legislation for example as regards insolvency and resolution legislations.

We are therefore in favour of the suggested Option 1, indirect harmonisation through voluntary, non-legislative coordination measures, and will describe the different areas where we think it is relevant to encourage greater convergence in covered bond laws through voluntary, non-legislative coordination measures, throughout our consultation answers. As will be described in the answers below, we do not think that such measures should extend to civil law regimes regarding insolvency, ranking of claims and the protection of creditors.

Q4: Specifically, if the Commission were to issue a recommendation to Member States as suggested in section 3 of part II would you consider that sufficient or should it be complemented by other measures (both legislative and non-legislative)?

We see no need for legislative measures. In our view, improved efficiency, transparency and comparability of covered bond markets is best accomplished through indirect, voluntary, non-legislative coordination measures based on high standards and best practices of the member states.

QUESTIONS – ISSUER MODELS AND LICENSING REQUIREMENTS. ROLES OF SPVs

Q1. Should the current licensing system be simplified to require a "one-off" authorisation only for all covered bond issuers based on common high level standards? What specific prudential requirements (that is, in addition to those in CRR and CRD) could be applied as a condition for granting a covered bond issuer license?

In the development of coordination measures, such as recommendations to Member States, high minimum requirements for issuing covered bonds would be beneficial in protecting the market participants and maintaining investor confidence. We thus support the proposal to have an authorisation prior to issuance. The licensing model used in Sweden is a one-off authorisation (special license) model requiring the issuer to fulfil certain requirements. These include, inter alia, that the issuer prior to authorisation must prove to the Swedish Financial Supervisory Authority (FSA) that the issuance will comply with relevant regulations. Moreover, the financial situation of the issuer must be stable enough to protect investors' interest. In addition, the issuer must in detail describe how it will conduct the covered bond business and manage the cover pool and the segregation of assets. The issuer must also provide a financial forecast for the three following years and a detailed description of the IT–systems that the issuer is planning to use for the covered bond activities.

QUESTIONS – ON-GOING SUPERVISION AND MONITORING OF COVER POOLS (PRE-INSOLVENCY)

Q1: In your view, would it be desirable for an EU covered bond Framework to set common duties and powers on competent authorities for the supervision of covered bond programmes and issuers? What specific duties and powers should be included in the Framework and/or EBA or ESMA Guidelines?

We are supportive of indirect harmonisation and see little need for legislative measures. In any coordination measures, such as recommendations to Member States, we support the development of a voluntary, non-legislative recommendation on how to set the duties and powers of the competent authorities. We agree that high quality of the on-going supervision is important for the confidence in the covered bond market and the investor protection. In our view, the competent authority should also have the power to withdraw the license to issue covered bonds or, if sufficient, issue a warning if the issuer does not comply with the requirements.

Q2: What are your views on the proposals set out in subsection 2.2 of Part III on the appointment of and legal regime for cover pool monitors?

In coordination measures, such as recommendations to Member States, we are supportive of the proposal to appoint an independent third party as a cover pool monitor, with high eligibility criteria, but see no need for any legislative measures. Also in a recommendation, the legal power, the responsibility and the duties of the cover pool monitor should be specified. In Sweden, the use of an independent third party appointed as a cover pool monitor has been an important tool for the Swedish FSA to audit and validate the accuracy of the cover pool and the compliance of coverage requirements. The monitor is appointed by the Swedish FSA and should meet high eligibility criteria regarding competence and knowledge in the areas of the covered bond market; credit granting processes; valuation of financial instruments and real estate; financial accounting; and IT-systems.

QUESTION – DUAL RECOURSE PRINCIPLE

Do you agree with the proposed formulation for "dual recourse"?

We are supportive of indirect harmonisation through voluntary, non-legislative coordination measures and see no need for legislative measures. As regards to the definition of dual recourse, we generally agree but find it important to stress that any coordination measures on covered bonds must also ensure that following the segregation of the cover pool post insolvency of the issuer, the cover pool as a separate entity can continue to service the payment obligations to the bondholders. Also, dual recourse should not be designed to imply the right to demand pre-mature liquidation of the assets in the cover pool, providing that the coverage requirements are fulfilled. On a final note, the proposed definition of issuer's default "*the issuer's default may be triggered upon its resolution or declaration of insolvency*" should be clarified to state that the default of the issuer must be determined by <u>national</u> insolvency and resolution legislation.

QUESTIONS – SEGREGATION OF THE COVER ASSETS

Q2. In your jurisdiction, what legal and practical steps are required in order to segregate effectively the cover assets from the issuer's insolvent estate or in resolution? Would it be necessary to serve a notification to each borrower of the issuer? Until notification is served, what is the legal status of any proceeds of the cover assets which may be paid directly into the insolvent estate or to the issuer in resolution?

The Swedish law for covered bonds requires the issuer to keep a register of outstanding covered bonds, collateral, substitute assets and, where applicable, derivatives contracts. Cover assets are subject to priority claims. Further, the issuer should keep cash flows accruing from the cover pool assets derivative contracts and covered bonds separated from the issuer's other funds. At the issuer's insolvency the cover pool assets are segregated from the issuer's other assets at the time of default. Cover pool assets are then used to fulfil the payments in the covered bonds, and will continue to be separated from the defaulted issuer's other assets unless coverage requirements are breached. No notification is needed to be sent to the borrowers.

In a gone concern scenario, if the coverage requirements are no longer fulfilled, cover pool assets will no longer be segregated from the issuer's other assets. However, covered bondholders still have a dual recourse to both the issuer and to the cover pool. But when the coverage requirements are no longer met, no more coupons will be paid. Instead, covered bondholders will be reimbursed by the nominal amount plus accrued interest of the bonds, through an ordinary bankruptcy process where they have a priority right to the assets in the cover pool at the time of default.

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QUESTIONS – LEGAL FORM AND SUPERVISION OF THE COVER POOL

Q1: Should the cover pool be incorporated as a regulated entity? In that case, what type?

In our view, the status of the cover pool is a matter of national insolvency law. We see no reason to require the pool to be incorporated as a regulated entity.

Q2: Who should be the supervisory authority for these purposes, the competent authority or the resolution authority?

This is an issue which is affected by insolvency and resolution procedures, so it should align with national law and therefore allow member state flexibility. Nevertheless, one of them must be in charge of this very important task.

QUESTIONS – RANKING OF COVER POOL LIABILITIES

Q1: Do you agree with the suggested ranking for cover pool liabilities? Is the wording proposed in subsection 3.3 of Part III sufficient to define clearly the claims that may arise, avoid confusion between claims and prevent claims in an unreasonable amount from arising?

As regards the ranking of liabilities, we believe that this should follow national insolvency regulations and are therefore not supportive of the suggested ranking of the cover pool liabilities.

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QUESTIONS – INTERACTION BETWEEN COVER POOL AND ISSUER IN INSOLVENCY/RESOLUTION

Q1. Are current provisions in EU law sufficient to deliver effective protection for bondholders in a resolution scenario involving covered bonds? In particular, is it sufficiently clear:

a) how the cover pool would be segregated under each possible resolution or recovery scenario of the issuer?

We would like to make the following general comment to the question posed regarding covered bonds and insolvency/resolution. A complete and uniform harmonisation of covered bond laws could give rise to different end-results in different jurisdictions, due to differences in the national legislations related to insolvency and resolution which would not be desirable. Insolvency law is currently adapted to each Member State's specific conditions in line with the principle of subsidiarity. Focus should be on harmonising the outcome i.e. an effective dual recourse mechanism and hence protection of bondholders – not on harmonisation of the rules and regulations per se.

QUESTIONS – RESIDENTIAL AND COMMERCIAL LOANS

Q1: Do you agree with the proposed definitions for "residential" and commercial loans" as cover assets? Should certain riskier residential or commercial loans (i.e. buy-to-let mortgages; second home loans; loans to real estate developers; etc.) be excluded from the cover pool or permitted subject to stricter criteria?

Q2: In relation to mortgage loans:

c) are minimum standards for mortgage rights in third countries necessary?

In any recommendation to Member States, we do not support the inclusion of residential and commercial mortgage loans of third countries in the cover pool.

Q3: In relation to LTVs:

a) what are your views on the proposals set out in subsection 4.1 of Part III on minimum LTVs?

We are supportive of indirect harmonisation through voluntary, non-legislative coordination measures and see little need for legislative measures. In any coordination measures, such as recommendations to Member States, we believe that LTV requirements should differ between the different types of assets in the cover pool, reflecting the different levels of risk. We support that LTV limits should be set for the calculation of collateral coverage levels in the cover pool and to determine the eligibility to the cover pool. Moreover, LTV levels should be measured on a specified property value as close to *market value* as possible, and should be updated regularly, and there should be clear requirements for the valuation of collateral.

In Sweden, the following LTV levels are applied to qualify for the covered bond pool: 75 per cent for mortgages, 70 per cent for agricultural real estate and 60 per cent for commercial real estate. The LTV threshold is constant during the entire lifetime of the loan and determines how large share of the loan can be included in the cover pool. This implies that if a mortgage has a LTV of 85 per cent at inception, the loan can contribute to the cover pool but only up to 75 per cent of the underlying collateral's value. If the value of the collateral decreases during the lifetime of the loan, the value included in the cover pool must be adjusted accordingly to 75 per cent LTV.

In our view, it is important to avoid a dogmatic binary approach where a loan that does not meet the required LTV limit is excluded from the cover pool. This may cause instability in a stressed market situation which in turn could have systemic implications for the financial sector. At the same time, it is equally important that the value included in the cover pool is adjusted so the total value of the cover pool reflects the value of the underlying collaterals, which otherwise would be misleading and deteriorate the investor confidence, especially in times of stress.

b) in the case of insured properties, should higher LTV limits be allowed if the insurance cover meets certain requirements and, if so, what should such requirements be? In what other cases should higher LTV limits be allowed? Could loan-to-income requirements be used to replace or complement LTV limits?

We believe that appropriate insurance arrangements should be a prerequisite in sound credit granting policies and do therefore not see any reason to allow higher LTV limits for insured properties. Regarding LTI requirements, it is our view that in any non-legislative coordination measure, LTI should not be allowed to replace LTVs. Covered bonds should be simple and transparent, and LTV should be the variable that sets the criteria.

e) should LTV limits be used to determine: eligibility (loan in/out) of loans at inception? Eligibility (loan in/out) of loans on an ongoing basis? Should they instead be used to simply determine contribution to coverage? A combination of the above?

As regards recommendations on LTV limits, these should be used to determine contribution to the coverage However, a dogmatic binary approach where a loan that does not meet the required LTV limit is excluded from the cover pool may cause instability in a stressed market situation. This may in turn have systemic implications for the financial sector.

Q4: In relation to the valuation of cover assets:

a) how frequently should the value be updated and in which way (revaluation, update of the initial valuation, and in which way)?

Regarding recommendations on the valuation of cover assets, we believe that the revaluation or update of the initial valuation should be done continuously reflecting the risk of downward changes in market values of the collateral. That is, with a high risk of decreasing market values of the collateral, the valuation and the contribution to the cover pool should be updated more frequently. In markets facing increasing prices, adjustment of valuation and contribution to the cover pool should be done conservatively. Market value should be the guiding principal and statistical valuation should be allowed, if it can be assured to be prudent.

b) what criteria should be applied to (i) the valuer and (ii) the valuation process to ensure that they meet the transparency and independence principles set out in the first and second subparagraphs of Article 229(1) CRR?

We believe that in any non-legislative recommendation to the Member States, the following criteria on the valuer and the valuation process should be included.

i) The valuer should have adequate and sufficient knowledge of valuation methods as well as the real estate market including knowledge about local conditions.

ii) The valuation should at a minimum fulfil the criteria stated in CRR article 229 (1) and should be conducted according to acknowledged and generally accepted valuation methods. Also, the documentation should be complemented with information of who the valuer is, valuation date and a description of assessment criteria. Statistical valuation should be allowed, if it can be assured to be prudent.

Q6: In light of the EBA's prudential concerns in relation to the use of RMBSs and/or CMBSs in cover pools, should the Framework exclude these assets completely from qualifying as cover assets (including, for these purposes, as substitution assets) or should they be allowed only subject to strict criteria and within the 10% limit currently permitted under Article 129 of the CRR? What is the added value and practical uses of RMBS/CMBS as collateral in your jurisdiction/issuer?

We are supportive of indirect harmonisation through voluntary, non-legislative coordination measures and see little need for legislative measures. In the development of coordination measures, such as recommendations, RMBSs and/or CMBSs should not be allowed in the cover pool. Such assets greatly increase complexity and reduce both simplicity as well as transparency. Either the loan is used in a covered bond as a standardised asset, or it is used in a securitisation. The two should be kept apart.

QUESTIONS – PUBLIC SECTOR LOANS

Q1: What are your views on the proposals for public sector loans as cover assets set out in subsection 4.1 of Part III?

In the development of coordination measures, such as recommendations, we support that member states' public sector loans are accepted as cover assets.

QUESTIONS – OTHER ASSET CLASSES: AIRCRAFT, SHIP AND SME LOANS

Q1: Should the Framework exclude aircraft, ship and SME loans from cover pools or should they be allowed only subject to strict criteria and limits? If so, what criteria and limits should be applied?

In the development of coordination measures, such as recommendations, we believe it will be important to limit the types of assets qualifying as collateral for the cover pool since the purpose is to decrease fragmentation. Unless the underlying assets are fairly homogeneous across markets, it will be hard to improve comparability, and the whole idea of increased financial market integration risk failing. Covered bonds with underlying collateral in SME-loans, aircraft and shipping are both different in nature and more heterogeneous compared to for example mortgages or public sector claims. Introducing covered bonds with such assets would therefore render the chances of reducing fragmentation and facilitating increased cross-border investment flows. As such we believe that the cover pools should be restricted to residential, commercial, and public sector loans, provided that they fulfil prudent criteria on LTV, valuation, etc. Such restriction would protect the robustness and reputation of covered bonds.

Q2: In relation to SME loans, is it possible to identify a category of "prime" SME loans as a potential eligible asset class for cover pools?

No, please see answer to question 1 above.

QUESTIONS – MIXED POOLS AND LIMITS ON EXPOSURES

Q1: Do you agree that mixed-asset cover pools should be allowed?

In the development of coordination measures, such as recommendations, we believe that mixed pools should be allowed, provided that there are certain restrictions on the assets' share of the cover pool and the asset quality. The Swedish regulation sets explicit limits to the respective shares of different assets in the pool, where commercial loans may constitute up to 10 per cent of the pool, and substitute collateral may constitute up to 20 per cent. In our view, while it is important to maintain homogeneity and high asset quality in the cover pool, it is important that issuers retain the possibility of adding high-quality collateral (i.e. sovereign exposures) to the pool if needed in order to fulfil the coverage requirements under periods of stress.

Q2: What are your views on the proposed limits on specific assets and concentration of exposures? Should any other limits or requirements apply?

Please see answer to question 1 above.

QUESTIONS – COVERAGE REQUIREMENT

1. Which option should be preferred for the Framework to formulate the coverage requirement and why?

a) a general requirement along the lines of Article 52(4) of the UCITS Directive, amended to include the wording suggested by the EBA;

b) a nominal coverage;

c) a net-present value coverage;

d) a net-present value coverage under stress; or

e) any other or a combination of the some or all of the above.

We are supportive of indirect harmonisation through voluntary, non-legislative coordination measures and see little need for legislative measures. In the development of coordination measures, such as recommendations, we favour a combination of all of the above-mentioned metrics, including matching requirements regarding duration and currency mismatches under stress. In particular, we would like to highlight the importance of considering both the nominal coverage and net-present value metrics.

Q2: If the coverage requirement were formulated as net-present value coverage under stress, should the stress tests be specified in any form in the Framework or ESMA/EBA regulatory guidelines? If so, what specific stress tests should be required and why?

In the development of coordination measures, such as recommendations, we are supportive of the idea of specifying a minimum interest rate change for a stressed scenario. While it is important to consider both the net-present value and nominal coverage requirements, one should remember that these two metrics do not guarantee adequate cash flow coverage. For instance, a large over-collateralisation, in nominal terms, may indicate adequate debt servicing capacity, but it might also render the net-present value test useless when it comes to assessment of cash flow coverage.

Q3. Should derivatives entered into in relation to the cover pool be taken into account for the purpose of determining the coverage requirement? If so, what valuation metric should be used for these purposes?

In the development of coordination measures, such as recommendations, we believe that derivatives should be taken into account when determining the coverage requirement. In our view, when considering the net-present value coverage both currency and interest rate derivatives could be used. In addition, when considering the nominal coverage currency derivatives should be used. There should however be strict requirements on the derivatives counterparties and collateral management for this purpose.

Q4. What exposures to credit institutions within the pool should be taken into account to determine the coverage requirement and why?

In the development of coordination measures, such as recommendations, we believe that *all* exposures to credit institutions to which the bondholders have a priority claim should be taken into account to determine the coverage requirement. According to the Swedish covered bond legislation, exposures to credit institutions may occur only in the case of substitute collateral (post specific approval from the Swedish FSA) and in the case of derivative contracts used to fulfil the coverage requirements.

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QUESTIONS – OVERCOLLATERALISATION

Q1: Should a quantitative mandatory minimum OC level be set in the Framework? If so, what should that level be and should it be the same for all types of covered bonds?

We are supportive of indirect harmonisation through voluntary, non-legislative coordination measures and see little need for legislative measures. In the development of coordination measures, such as recommendations, on over-collateralisation, we refer to Article 8(g) in the ESMA second consultation paper: *Regulatory Technical Standards on risk-mitigation techniques for OTC-derivative contracts not cleared by a CCP*, which specifies that the covered bond which the OTC derivative contract is associated with is subject to a regulatory collateralisation requirement of at least 102 per cent.

Q2: If a mandatory minimum OC level were set in the Framework, should there be exceptions to the requirement? (for example where the issuer applies a precise "match funding model" or where certain targeted liquidity and market risk mitigation measures are used – see subsection 4.3 of Part III)

In the development of coordination measures, such as recommendations, we do not believe that any exceptions to a minimum OC requirement should be proposed.

Q3: Should the Framework set a maximum level of permitted OC? If so, when and at what level?

We are supportive of indirect harmonisation through voluntary, non-legislative coordination measures and see little need for legislative measures. In the development of coordination measures, such as recommendations, we do not believe that there is a need, at this point, to propose a maximum level of over-collateralisation across the EU. However, it should be clarified what the high levels of over-collateralisation really means in case of resolution or insolvency. Recognising that a high level of OC is a substantial source of asset encumbrance, it is important to address the risks associated with high levels of asset encumbrance and further analysis is required.

QUESTIONS – MARKET AND LIQUIDITY RISKS

Q1: In your view, are OC levels adequate to mitigate market and liquidity risks in the absence of targeted measures such as those described in subsection 4.3 of Part III?

We are supportive of indirect harmonisation through voluntary, non-legislative coordination measures and see little need for legislative measures. In the development of coordination measures, such as recommendations, we do not see any over-collateralisation level as adequate to mitigate market or liquidity risk in covered bonds. Since a large over-collateralisation may in fact disguise considerable mismatches in interest rate terms and currency between the cover pool and the issued securities, it might not be optimal to mitigate interest rate and currency risks.

To consider over-collateralisation as a risk mitigant to market and liquidity risks, it is required to use illiquid assets to generate liquidity. This could be done by using the excess collateral for raising cash which might be difficult, especially in stressed situations and post-default. Liquidity could also be generated by using over-collateralisation in the form of mortgages to handle liquidity flows by selling these mortgages, which might also have pro-cyclical effects.

Instead, the bondholders' contracted payments should be ensured by prudent management of market risks and liquidity risks, such that the terms and conditions of the cover pool and the related derivatives, together with cash in the cover pool, can be forecasted to cover the payment obligations over a defined time period.

Q2: Should the Framework lay down specific requirements on the use of derivatives as suggested in subsection 4,3 of Part III? How should "eligible counterparties" be defined for the purposes of entering into permitted derivatives?

In the development of coordination measures, such as recommendations, we believe that the possibility to use derivatives to handle mismatches between the cover pool and the issued securities provides the issuers with a flexibility which adds efficiency to the economy. To lower the risk for systemic instability and concentration risks, it is important to consider if specific requirements for the use of derivatives are needed.

Reaching a consistent definition of derivatives used for hedging purposes might prove difficult. However, by requiring such cash-flow coverage as proposed in the answer to question 1 to hold also under stressed assumptions, the use of derivatives for other purposes than proper hedging can be strongly limited and counteracted.

Specific rating-requirements for derivative counterparties at the initiation of contracts are one way to reduce counterparty credit risk. Another way of decreasing the counterparty credit risk is by ensuring that derivative exposures are properly collateralised.

Furthermore, it is of utmost importance that the derivatives do not terminate following the insolvency or resolution of the issuer, so that they can continue to fulfil their risk mitigating role post-default. It is also strongly advisable that they rank pari passu with the claims of covered bondholders, in order to ensure the payment obligations from the issuer to the derivative counterparty. The continuation of the derivatives in a default could possibly be assured by central clearing of such derivatives and any coordination measure should not disincentives this option.

Q4. On the EBA's liquidity buffer recommendation:

a) should covered bond issuers hold a "liquidity buffer" to mitigate liquidity risk in the cover pool and, if so, in what circumstances?

Given a coverage requirement on cash flows, as described in the answer to question 1, no specific liquidity buffer may be needed.

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QUESTIONS – TRANSPARENCY REQUIREMENTS

Q1. What are your views on the current disclosure requirements set out in Article 129(7) of the CRR? If more detailed requirements were preferred, do you agree that issuers should disclose data on the credit, market and liquidity risk characteristics to a more granular level? If so, what data and to what level of granularity?

In the development of coordination measures, such as recommendations, on transparency, we are supportive of high transparency and our general view is that the more transparency, the better. However, it is not just a question of quantity. Information on the covered bonds and the cover pools should be presented in a coherent and effective way.

In addition, transparency requirements may not always benefit from being regulated in legal texts. Experiences from private sector initiatives have in many cases been good. Given the ongoing initiative led by the ECBC on transparency regarding covered bonds and their cover pools, we would argue it is worth letting that work have a chance to come into effect. The ECBC's work on a harmonised transparency template (HTT) was allegedly finalised in September, and the ECBC has indicated it will be in place from 1 Jan 2016, with a phase-in period of one year. By the start of 2017, HTT should be fully operational. Once in place, supervisors could assess its merits and evaluate if it is satisfactory.