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Consultation Paper

on Draft Regulatory Technical Standards (RTS)

on close correspondence between the value of an institution’s covered bonds and the value of the institution’s assets relating to the institution’s own credit risk under Article 33 of Regulation (EU) 575/2013 (Capital Requirements Regulation - CRR)

Consultation Paper on Draft Regulatory Technical Standards (RTS) on close correspondence between the value of an institution's covered bonds and the value of the institution's assets relating to the institution's own credit risk under Article 33 of Regulation 575/2013

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1. Responding to this consultation

The EBA invites comments on all proposals put forward in this paper.

Comments are most helpful if they:

- respond to the question stated;
- indicate the specific point to which a comment relates;
- contain a clear rationale;
- provide evidence to support the views expressed / rationale proposed; and
- describe any alternative regulatory choices the EBA should consider.

Submission of responses

To submit your comments, click on the 'send your comments' button on the consultation page by 1.09.2013. Please note that comments submitted after this deadline, or submitted via other means may not be processed.

Publication of responses

Please clearly indicate on the consultation form if you wish your comments to be disclosed or to be treated as confidential. A confidential response may be requested from us in accordance with the EBA's rules on public access to documents. We may consult you if we receive such a request. Any decision we make not to disclose the response is reviewable by the EBA's Board of Appeal and the European Ombudsman.

Data protection

The protection of individuals with regard to the processing of personal data by the EBA is based on Regulation (EC) N° 45/2001 of the European Parliament and of the Council of 18 December 2000 as implemented by the EBA in its implementing rules adopted by its Management Board. Further information on data protection can be found under the Legal notice section of the EBA website.

2. Executive summary

Regulation 575/2013 sets out requirements related to unrealised gains and losses on liabilities valued at fair value resulting from changes in the own credit standing of the institution. Regulation 575/2013 will apply from 1 January 2014 and mandates the EBA to prepare draft regulatory technical standards (RTS) in this area.

This Consultation Paper puts forward a draft RTS, as mandated by Article 33(4) of Regulation 575/2013, relating to prudential filters applied to own funds (cash flow hedges and changes in the value of own liabilities). In particular it requires the EBA to further specify what constitutes the close correspondence between the value of the bonds and the value of the assets, as mentioned in paragraph 3, (c) related to Article 33 of Regulation 575/2013.

Article 33(3) specifies that without prejudice to paragraph 1, (b) an institution may include the amount of gains and losses on its liabilities in own funds where all the following conditions are met:

(a) the liabilities are in the form of bonds as referred to in Article 52(4) of Directive 2009/65/EC;
(b) the changes in the value of the institution's assets and liabilities are due to the same changes in the institution’s own credit standing;
(c) there is a close correspondence between the value of the bonds referred to in point (a) and the value of the institution's assets;
(d) it is possible to redeem the mortgage loans by buying back the bonds financing the mortgage loans at market or nominal value.

In general, changes in gains and losses on its liabilities following changes in own credit risk should not lead to changes in the capital position. The reason for the rule is that it is not considered prudent for the regulatory capital to strengthen when the fair value of a liability decreases due to an increase in own credit risk (own credit standing). However, in special cases, where the fair value of the issued covered bond, i.e. the liabilities of the institution, determines the fair value of assets, a close correspondence is considered to exist between the value of the liabilities and the value of the institution’s assets, justifying that gains and losses on liabilities following changes in own credit risk can be taken into account. It should be noted, that in this particular case, the change in the asset value off-sets the change in the liabilities, leaving the capital position unchanged.

3. Background and rationale

Background and rationale on fair value gains and losses that result from changes in the own credit standing of the institution

According to Article 33(1)(b) of Regulation 575/2013, unrealised gains and losses on liabilities valued at fair value resulting from changes in the own credit standing of the institution are not included in own funds. The reason for the rule is that it is not considered prudent for the regulatory capital to strengthen when the value of a liability that is valued at fair value decreases due to an increase in own credit risk (own credit standing).

Example 1: Own credit risk affects equity

Balance sheet Year 0

Assets	Liabilities and equity
Securities (50)	Issued bonds (100)
Loans and advances (100)	Equity (50)
Total (150)	Total (150)

Balance sheet Year 1 after decrease in fair value of issued bonds

Assets	Liabilities and equity
Securities (50)	Issued bonds (100-10)
Loans and advances (100)	Equity (50 + 10)
Total (150)	Total (150)

If the increase in equity was recognised following the drop in value of the issued bonds, the capital position would naturally increase, but the increase would not necessarily reflect equity that is available. In order for the equity to be available, the institution would need to realise this value by redeeming the issued bonds at market value, typically through purchases. It does not appear prudent to assume that an institution with a deteriorating credit standing would have access to the funding or have the cash at hand necessary to exploit this drop in the value of the issued bonds. Hence unrealised gains and losses on liabilities valued at fair value resulting from changes in the own credit standing is as a general rule not accepted.

In some specific cases, the change in fair value of the liabilities (including changes due to the institution's own credit standing) is offset by a change in the fair value of the assets measured at fair value. In this case, any gains or losses due to changes in the value of liabilities are offset by losses or gains due to a corresponding change in the value of assets, and the financial institution makes neither a profit nor a loss.

Example 2: Direct match between value of bonds and loans

Balance sheet Year 0

Assets	Liabilities and equity
Securities (50)	Issued bonds (100)
Loans and advances (100)	Equity (50)
Total (150)	Total (150)

Balance sheet Year 1 after decrease in fair value of issued bonds

Assets	Liabilities and equity
Securities (50) Loans and advances (100-10)	Issued bonds (100-10) Equity (50)
Total (140)	Total (140)

Balance sheet Year 1 after increase in fair value of issued bonds

Assets	Liabilities and equity
Securities (50) Loans and advances (100+10)	Issued bonds (100 +10) Equity (50)
Total (160)	Total (160)

This treatment is also reflected in the accounting rules where IFRS 9, paragraph 5.7.7. requires presentation of changes in fair value of a financial liability designated at fair value that is attributable to changes in the credit risk of that liability in "Other Comprehensive Income" unless this would create or enlarge an accounting mismatch in profit or loss. In such cases all gains or losses on the liability shall be presented in profit or loss.

Article 33(3) of Regulation 575/2013 specifies that an institution may include the amount of gains and losses on its liabilities in own funds where all the following conditions are met:

(a) the liabilities are in the form of bonds as defined in Article 52(4) of Directive 2009/65/EC;
(b) the changes in the value of the institution's assets and liabilities are due to the same changes in the institution's own credit standing;
(c) <u>there is a close correspondence between the value of the bonds referred to in point (a) and the value of the institution's assets</u>;
(d) it is possible to redeem the mortgage loans by buying back the bonds financing the mortgage loans at market or nominal value.

For example, due to the nature of the Danish mortgage system, at some banks, there is a direct link between a mortgage loan provided to a borrower and the corresponding covered bond financing that same loan – so-called match funding – and a connected special option for the borrower. This option allows the customers to buy back the specific covered bond financing the mortgage loan in the market and deliver the covered bond to the mortgage bank as an early prepayment of the loan.

The value of the mortgage loan is thus directly connected to the value of the corresponding covered bond. An increase in the value of the bond means a corresponding increase in the value of the mortgage loan, and a decrease in the value of the corresponding covered bond means a similar decrease in the value of the mortgage loan.

For banks with mortgage business models where a direct link between the value of the mortgage loan and the corresponding bond exists the gains and losses should be net of any changes in the corresponding assets valued at fair value that are due to the same changes in the institutions' own credit standing, so that no realised or unrealised gain is generated and no change in value of own funds occurs. Furthermore, for such banks, an increase in own credit risk would not result in an additional funding risk. This is because there is no refinancing risk with respect to the mortgage loans following repayment of the covered bonds due to the pass-through system, which creates a match between the outstanding value mortgage loans granted and the covered bonds issued.

Article 33(4) mandates the EBA to further specify what constitutes the close correspondence between the value of those own issued covered bonds and the value of the institution's assets.

The nature of RTS under EU law

The draft RTS are produced in accordance with Article 10 of the EBA Regulation[1]. In accordance with Article 10(4) of the EBA Regulation, they shall be adopted by means of regulations or decisions.

In accordance with EU law, regulations are binding in their entirety and directly applicable in all Member States. This means that, on the date of their entry into force, they become part of the national law of the Member States automatically without need for further transposition into national law.

Presenting these rules in the form of a draft Commission regulation should ensure a level-playing field by preventing divergent national interpretations in transposition and thereby facilitating the cross-border provision of EU financial services.

The EBA has developed these RTS proposals on the basis of Regulation 575/2013[2], published in the *Official Journal of the European Union* on the 28 June 2013. The EBA will review the draft RTS before submission to the Commission by 30 September 2013 to ensure that they take of account changes arising out of the consultation process

[1] Regulation (EU) No 1093/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Banking Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/78/EC.
[2] Regulation 575/2013 can be found; http://eur-lex.europa.eu/JOHtml.do?uri=OJ:L:2013:176:SOM:EN:HTML

4. Draft RTS on close correspondence between the value of an institution's covered bonds and the value of the institution's assets relating to the institution's own credit risk under Article 33 of Regulation 575/2013

COMMISSION DELEGATED REGULATION (EU) No …/…

supplementing Regulation (EC) No 575/2013 of the European Parliament and of the Council by way of regulatory technical standards for determining what constitutes the close correspondence between the value of an institution's covered bonds and the value of the institution's assets

THE EUROPEAN COMMISSION,

Having regard to the Treaty on the Functioning of the European Union,

Having regard to Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012[3], and in particular to the Article 33(4) thereof,

Whereas:

1. Gains or losses on liabilities of the institution resulting from changes in its own credit risk, should not, in principle, be included as an element of own funds. However, in business models based on the strict match funding or balance principle, the above rule is disapplied, on the premise that a decline or an increase in value of a liability is fully offset by a corresponding decline or increase in value of the asset, whom with that liability is fully matched.
2. In this context, it is important to set the requirements for determining whether a close correspondence exists between a liability consisting in a covered bond under Article 52(4) of the Directive 2009/65/EC and the value of the institution's assets.
3. Close correspondence should be reflected in the accounting treatment of these bonds and mortgages, without which, it would not be prudent to recognise gains and lossess stemming from changes in own credit risk.
4. This Regulation is based on the draft regulatory technical standards submitted by the European Banking Authority to the Commission.
5. The European Banking Authority has conducted open public consultations on the draft regulatory technical standards on which this Regulation is based, analysed the potential related costs and benefits and requested the opinion of the Banking

[3] OJ L 176, 27.6.2013, p. 1.

Stakeholder Group established in accordance with Article 37 of Regulation (EU) No 1093/2010.

HAS ADOPTED THIS REGULATION:

Article 1

Definition

"*delivery option*" is the possibility to redeem the mortgage loan by buying back the covered bond at market or at nominal value in accordance with Article 33 (3d) of the Regulation 575/2013.

Explanatory Box

A feature currently unique in Europe to the Danish mortgage finance system is borrowers' possibility of terminating loans by delivering the bonds behind the loan to the mortgage bank. Mortgage loans issued under the pass-through system are typically structured to allow borrowers to buy back their own loans in the bond market without incurring any penalty. However, borrowers must pay commission and other trading costs. The buyback opportunity applies to all loan types such as callable loans, Adjustable Rate Mortgages (ARMs) and floating-rate loans. The pass-through system implies a perfect match between the loans granted and the bonds issued. Bond issuers may therefore offer borrowers loan termination against delivery of the underlying bonds. The buyback opportunity follows the following process: i) the issuer informs the borrower of the exact nominal amount of bonds which is to be bought back to match the loan in question, ii) the borrower buys the bonds in the market, iii) the borrower delivers the bonds to the issuer and iv) the issuer terminates the loan agreement by eliminating the loan from its assets and writing down its liability by the value of the bonds bought back, for the same amount.

Article 2

Close correspondence

1. Subject to paragraph 2 of this article, a close correspondence between the value of a covered bond and the value of the institutions assets is deemed to exist when all the following conditions are met:

a) The fair value of the assets underlying the covered bond issued by the institution is at all times equal to the fair value of the covered bonds. The fair value is determined according to the applicable accounting framework.

b) The mortgage loan underlying the covered bond issued by the institutions to finance the loan may be at any time redeemed by the borrower by buying back the covered bond at market or nominal value (exercise of the delivery option).
c) There is a transparent mechanism for determining the fair value of mortgage loans and the covered bond. Determining the mortgage loan’s value should include fair valuing the delivery option as defined in article 1.

2. A close correspondence does not exist in each of the following cases:
a) Net profit or loss arises from changes in the value, determined according to paragraph 1 of the present article, either of the covered bond or the underlying mortgage loan with the embedded delivery option.
b) A change in the value of the covered bond is not fully offset by a corresponding change in the value of the underlying mortgage loan with the embedded delivery option.
c) A change in the value of the covered bonds results in an ultimate increase or decrease of the institution’s own funds.

Article 3

Entry into force

This Regulation shall enter into force on the day following that of its publication in the Official Journal of the European Union.

This Regulation shall be binding in its entirety and directly applicable in all Member States.

Done at Brussels,

For the Commission
The President

[For the Commission
On behalf of the President

[Position]

5. Accompanying documents

5.1 Draft cost- benefit analysis / impact assessment

Introduction

1. Article 15(1) of the EBA Regulation (Regulation (EU) No 1093/2010 of the European Parliament and of the Council) establishes that the draft technical standards developed by the EBA be accompanied by the analysis of the 'potential related costs and benefits' (unless such analysis is disproportionate in relation to the scope and impact of the draft technical standards concerned or in relation to the particular urgency of the matter).

2. Article 33(4) of Regulation 575/2013, related to prudential filters to own funds, requires the EBA to draft regulatory technical standards (draft RTS) further specifying what constitutes the close correspondence between the value of the covered bonds, as defined in Article 52(4) of Directive 2009/65/EC, and the value of the institution's assets. The EBA must submit the draft RTS to the European Commission by 30 September 2013.

Problem definition

3. Basel II, Basel III and Directive 2006/48/EC establish, as a general principle, that institutions shall exclude from own funds unrealised gains and losses on liabilities valued at fair value resulting from changes in the own credit standing of the institution.

4. This regulatory approach to own funds aims to ensure full transparency of reported regulatory capital and, in particular, at avoiding that a worsening of the institution's own credit standing might result in a counterintuitive increase in the reported levels of own funds resources. The (unrealised) gains on fair valued liabilities stemming from increasing own credit risk are gains that the institution is less likely to realise. More importantly, they result in a higher reported capitalisation of the institution in times of its own financial distress, when it is particularly important for regulatory capital to reflect fully the actual loss absorbency capacity of the institution.

5. A counterintuitive and non prudent own funds treatment of liabilities would contribute to undermining the resilience of institutions and the effectiveness of financial supervision. In addressing these issues, Article 33 of Regulation 575/2013 contributes to the general regulatory objective of safeguarding financial stability.

6. Through Article 33(3), Regulation 575/2013 establishes the conditions under which gains and losses on fair-valued liabilities stemming from own credit risk changes can be included in own funds due to the fact that offsetting value adjustments will be applied on the assets side of institutions' balance sheets, as a result of the same changes in institutions' own credit risk profiles. Regulation 575/2013 allows for such exception in the case of institutions issuing mortgage loans that are financed by covered bonds and that can be pre-paid by the borrower at par value or by purchasing the corresponding bonds on the secondary markets. When all the conditions of close correspondence between the market value of the bonds and the

market value of the loans apply, offsetting fair value changes taken to own funds results in an overall unchanged level of regulatory capital for the reporting institution.

7. The close economic correspondence between the fair value of the liabilities (covered bonds) and of the assets (mortgage loans) guarantees that events causing changes in own credit risk standing do not result in changes to the reporting institution's levels of regulatory capital.

8. In these cases institutions can fully reflect in their regulatory own funds the effects of changes in their own credit risk standing of the fair value of their liabilities without undermining the own funds figures transparently reflecting the capitalisation of institutions during own financial distress. It should be noted, that by allowing the changes in liabilities, the capital position is left unchanged for these institutions, hence ensuring a similar treatment as other institutions.

Objectives of the technical standards

9. The proposed draft technical standards aim to establish a harmonised understanding of the conditions that determine a close correspondence between the value of covered bonds, as defined in Article 52(4) of Directive 2009/65/EC, and the value of the institution's assets, in order to ensure a transparent and prudent own funds treatment of the mortgage funding scheme identified in Article 30(3) of Regulation 575/2013.

Option considered and Impact

10. Article 33(3) of Regulation 575/2013, and the provisions on the 'close correspondence' proposed by these draft RTS, are not expected to result in any compliance costs for institutions nor for National Supervisory Authorities.

11. 'Close correspondence' referred to in Article 33(3)(c) of the Regulation is further specified by these draft RTS so as to ensure a harmonised, prudent and intuitive own funds treatment of a specific mortgage funding scheme. By contributing to the general regulatory objective of safeguarding financial stability, the proposed own funds treatment is expected to result in economic benefits, for involved stakeholders as well as for the EU financial system as a whole.

12. Due to the national implementation of EU regulation currently in force, the proposed own funds treatment already applies in the only EU jurisdiction (Denmark) where, according to available evidence, the targeted mortgage funding model is being implemented. The harmonisation put forward in the Single Market by Article 33 of Regulation 575/2013, as further enriched by the proposed draft RTS, ensures that the same regulatory objectives and economic benefits will apply to the same business model across EU jurisdictions.

13. The traditional model, characterised by the features of close correspondence between the bond value and loan value and by the par value and market value pre-payment options, represented the only existing mortgage funding scheme in Denmark until 2007. Since then, with the introduction of EU legislation on the issuance of covered bonds, Danish mortgage

banks have been allowed to issue mortgage covered bonds and Danish commercial banks to issue covered bonds.

14. Available data from the Danish mortgage industry, covering years 2008-2012, shows that the use of the traditional ‘mortgage bond’ has been increasingly replaced by the use of CRD-compliant ‘mortgage covered bonds’ and ‘covered bonds’. The traditional mortgage bond, that used to represent just over than 80 % of the total outstanding covered bonds in the first quarter of 2008, represented only approximately 20 % of total outstanding covered bonds as of the last quarter of 2012, with the remaining 80 % being represented by ‘mortgage covered bonds’ and ‘covered bonds’.

15. Evidence from the Danish mortgage industry also confirms this, although, under the new CRD-compliant forms of ‘mortgage covered bonds’ and ‘covered bonds’, the close correspondence features (also referred to as ‘specific balance principle’ or ‘specific pass-through principle’), which used to characterise the traditional mortgage bond, are still being embedded in most of the outstanding mortgage financing schemes following the 2007 reform. One of the few exceptions being represented by the ‘covered bonds’ issued by universal banks, which instead adhere to the so-called Eurostyle issuing scheme.