European Banking Authority

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EBA FINAL draft Regulatory Technical Standards

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)

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1. 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 final draft RTS 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. This draft RTS, as mandated by Article 33(4) of Regulation 575/2013, relates to prudential filters applied to own funds (cash flow hedges and changes in the value of own liabilities).

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.

2. 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) 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.

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.

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[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.

3. EBA Final 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 …/..

of XXX

COMMISSION DELEGATED REGULATION (EU) No …/…
supplementing Regulation (EU) No 575/2013 of the European Parliament and of the Council with regard to 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 20132, and in particular 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 losses 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 Stakeholder Group established in accordance with Article 37 of Regulation (EU) No 1093/2010.

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

HAS ADOPTED THIS REGULATION:

Article 1 - Definitions

1. “*covered bond*’ is a bond as referred to in Article 52(4) of Directive 2009/65/EC.
2. “*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.

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 institution’s assets is deemed to exist when all the following conditions are met:

(a) Any changes in the fair value of the covered bonds issued by the institution will at all times result in equal changes in the fair value of the assets underlying the covered bonds. The fair value is determined according to the applicable accounting framework.

(b) The mortgage loans underlying the covered bonds issued by the institution to finance the loans may be at any time redeemed by buying back the covered bonds at market or nominal value (exercise of the delivery option).

(c) There is a transparent mechanism for determining the fair value of the mortgage loans and of the covered bonds. Determining the value of the mortgage loans should include fair valuing the delivery option as defined in Article 1 (2) of this Regulation.

2. A close correspondence does not exist whenever a net profit or loss arises from changes in the value, determined according to paragraph 1 of this Article, either of the covered bonds or the underlying mortgage loans with the embedded delivery option.

Article 3 – Entry into force

This Regulation shall enter into force on the twentieth 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]

4. Accompanying documents

4.1 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.

4.2 Feedback on the public consultation

The EBA publicly consulted on the draft proposal contained in this paper.

The consultation period stared on 19 July 2013 and ended on 1 September 2013. 2 responses were received and published on the EBA website.

The points raised by the industry as with regard to these draft RTS provide relate to the proposed criteria to define “close correspondence” between the value of a covered bond and the value of the institutions assets.

The feedback statement below presents a summary of the main issues and comments arising from the consultation, the analysis and discussion triggered by these comments and the actions taken to address them if deemed necessary.

Changes to the final draft RTS have been incorporated as a result of the responses received during the public consultation.

Summary of responses to the consultation and the EBA's analysis

Comments	Summary of responses received	EBA analysis	Amendments to the proposals
Responses to questions in Consultation Paper EBA/CP/2013/31			
Question 1.	Article 2, paragraph 1, litra a of the consultation paper states that 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. We suggest that it is reformulated as "Any changes in the fair value of the covered bonds issued by the institution will at all times result in equal changes in the fair value of the assets underlying the covered bonds". The fair value of the assets (mortgage loans) underlying the covered bonds is not at all times equal to the fair value of the covered bonds. The mortgage loans' fair value is deter-mined as the fair value of the covered bonds reduced by reserves to cover changes in ex-pected credit losses on the mortgage loans (the fair value of the credit risk on the borrow-ers). Hence, the institution's own funds will not be affected by changes in own credit risk, as any changes in fair value of the covered bonds will be equally reflected in fair value of the mortgage loans. This notwithstanding, own funds is reduced by the reserves to cover the expected credit losses on the mortgage loans.	EBA believes the comments are from a technical nature and that they do not change the intention of the proposed criteria to define "close correspondence" between the value of a covered bond and the value of the institutions assets and has taken them into account.	Change to Article 2.1(a) and Article 2.1(b)

	Article 2, paragraph 1, litra b of the consultation paper states that a close correspondence re-quires that “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).” For technical reasons we suggest that the term “by the borrower” be omitted from the text. The borrower always has the option to redeem the mortgage loan. In some cases, however, mortgage loans are distributed through an intermediary bank. When redeeming the mortgage loan, the covered bonds will be bought by the borrower or the intermediary bank and delivered to the issuer. Thus, it is not always technically the borrower that buys back the covered bonds in the market when redeeming the loan.		