

Question ID

2024_7124

Legal act

Regulation (EU) No 575/2013 (CRR)

Topic

Securitisation and Covered Bonds

Article

129

Paragraph

1

Subparagraph

c

COM Delegated or Implementing Acts/RTS/ITS/GLs/Recommendations

Not applicable

Article/Paragraph

Not applicable

Type of submitter

Credit institution

Subject matter

Exposure to credit institutions in the form of derivative contracts

Question

Should "exposure" also consider and include cash collateral held by the covered bond issuer from its swap counterparty?

Background on the question

Covered bonds are normally hedged with swaps, especially for currency risk and especially by issuers outside the Eurozone when issuing in EUR (issuers in Norway for example). When collateral

posting by the covered bond issuer's swap counterparty is subject to contract (ISDA Schedule and CSA), we think that the word "exposure" in Article 129(1)(c) CRR should also include, or regard collateral held from the swap counterparty.

With regards to covered bond swaps, the Regulation (EU) 2016/2251, Article 30(1)(a) is important in this context. Here it is regulated that when covered bond swaps are not centrally cleared but are OTC swaps (as must be the case with all currency swaps), variation margin in the form of cash must be collected from the swap counterparty.

A sole focus on the covered bond swap counterparty's Credit Quality Step with no regard for the collateral posted by this counterparty to the covered bond issuer (cover pool) neglects the underlying economic reality when it comes to exposure. This subject matter is important if a bank, which is a cover bond swap counterparty, is downgraded to CQS3 during a running swap contract. That would mean that such a counterparty must be replaced to fulfil Article 129 CRR, unless the national regulator has allowed CQS3 due to concentration issues in the market (however, the argument is not about allowing new derivatives contracts with CSQ3 counterparties, but what happens upon a downgrade to a counterparty in a running contract). However, when such a swap counterparty has posted as collateral all mark-to-market amounts it owes under a swap contract in cash to the covered bond issuer, we think that when assessing the covered pool's exposure, this should be included. That is the essence of why collateral is posted. Moody's rating methodology also requires a collateral buffer to be posted above the Mark-to-market exposure in such cases (swap counterparty loses a A3 rating), and many issuers are following this methodology.

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26/06/2024

Final publishing date

07/11/2025

Final answer

According to Article 111(6) and (7) of Regulation (EU) 575/2013 (hereafter referred to as 'CRR'), the exposure towards credit institutions in the form of derivative contracts for the purpose of counterparty credit risk capital requirements shall be determined net of cash collateral received, in line with the provisions set forth in Chapter 4 and Chapter 6 of the CRR.

Collateral received by the covered bond issuer has the purpose of mitigating the exposure to the derivative transaction's counterparty. Cash collateralisation has the effect of increasing the credit (or – equivalently – decreasing the debit) of the issuer's general operating account with the central bank. As such, being indistinguishable within the issuer's estate, it cannot be segregated for the benefit of the covered bond programme (e.g. by way of annotating the amount of cash collateral received with the cover register entry of the associated derivative transaction).

Conversely, the collateral received constitutes a latent obligation of the issuer/covered bond estate to return it to the counterparty/collateral provider upon a revaluation of the derivative transaction's netting set no longer requiring variation margining to that extent, thus constituting a latent coverable obligation according to point c in Article 15 paragraph 3 sub-paragraph 1 of Directive (EU) 2019/2162 (hereafter referred to as 'CBD'). A covered bond estate's inability to honour this redemption obligation, which is theoretically due at any time, would constitute a breach of contract

or a failure-to-pay under standard governing documentation resulting in early termination of the derivative transaction, in line with point d of Article 11 paragraph 1 CBD, thereby preventing the continuation of the derivative transaction, required by point d of Article 11 paragraph 1 CBD, just as it may become relevant for covered bond investor protection due to the transitioning from first to second recourse.

Therefore, for cash collateral to be taken into account when determining the extent to which a cash-collateralised derivative transaction within the meaning of Article 11 CBD counts as an exposure to the counterparty credit institution and, thus, utilises the corresponding CQS-linked limits as required by Article 129 paragraph 1a CRR, it needs to be fully segregated for the benefit of the covered bond programme, cf. Article 12 paragraph 1 sub-paragraph 2 CBD. This requirement implies the following conditions shall be met:

- there is a legally valid and enforceable agreement that the received collateral may be used to offset amounts due to the covered bond issuer upon involuntary early termination ("breach of contract") of the derivative (for instance, because of clauses of netting-by-novation of close-out amounts in ISDA Master Agreement), as per Article 30(1)(a) of CDR (EU) 2016/2251.
- the received cash collateral is effectively segregated for the benefit of the covered bond investors, in line with the national requirements transposing Article 12 paragraph 1 CBD.

The first condition ensures that the purpose of the collateralisation of mitigating the issuer's/covered bond estate's exposure to the counterparty in case of (involuntary) early termination of the derivative transaction while the market valuation of the underlying derivative constitutes a claim of the issuer/covered bond estate is met. The second condition is meant to enable the covered bond estate – in case of estate separation – to fulfil the (potentially very short-term) obligation to return the received collateral to the counterparty under an ongoing derivative transaction.

In the absence of the above conditions, cash collateral shall not be considered for netting purposes with respect to derivatives contracts.

Status

Final Q&A

Answer prepared by

Answer prepared by the EBA.
