



## Relief for Covered Bonds as ESMA refines the Clearing Obligation

On August 16, 2012, the European Market Infrastructure Regulation (“**EMIR**”) came into force, defining the obligations of in-scope entities, amongst other things, to (1) centrally clear certain over the counter derivatives trades and (2) exchange collateral in respect of any trades that are considered unsuitable for clearing. Recitals 16 and 23 of EMIR, however, specify that European legislators recognise these requirements could potentially have a damaging effect on the functioning of the covered bond market. In particular, Recital 16 states that when preparing its technical rules on the applicability of the clearing obligation to particular classes of derivatives, the European Securities and Markets Authority (“**ESMA**”) should account for “the specific nature of OTC derivative contracts which are concluded with covered bond issuers or with cover pools for covered bonds”. As highlighted in a July 2013 discussion paper<sup>1</sup> relating to the clearing obligation (the “**Discussion Paper**”), ESMA sees this, not as a requirement to provide a blanket exemption from centrally clearing all covered bond swaps but rather to take into consideration the specific nature of the aforementioned contracts.

Two years after EMIR came into force and, partly as a consequence of a rather lengthy authorisation process for Central Clearing Counterparties (“**CCPs**”), ESMA is only now beginning to define and clarify which trades it believes should be subject to the clearing obligation. On July 11, 2014, ESMA published two consultation papers<sup>2</sup>, each setting out its views and requesting market feedback, in respect of preparing regulatory technical standards (“**RTS**”)<sup>3</sup> governing these issues in the context of (1) interest rate and (2) credit derivatives (the “**Consultations**”). Similar consultations in respect of other classes of derivatives are likely to be published in the future.

Within the Consultation focused on interest rate derivative products (the “**IR Consultation**”), ESMA sets out an analysis of the covered bond market and the specificities of covered bond derivatives. This client alert provides some background in respect of the covered bond derivatives market, considers ESMA’s analysis of the applicable clearing-related issues and sets out its conclusions as regards the regulatory status of derivatives entered into in connection with covered bonds.

<sup>1</sup> [http://www.esma.europa.eu/system/files/2013-925\\_discussion\\_paper\\_-\\_the\\_clearing\\_obligation\\_under\\_emir\\_0.pdf](http://www.esma.europa.eu/system/files/2013-925_discussion_paper_-_the_clearing_obligation_under_emir_0.pdf).

<sup>2</sup> [http://www.esma.europa.eu/system/files/esma-2014-799\\_irs\\_-\\_consultation\\_paper\\_on\\_the\\_clearing\\_obligation\\_no\\_1\\_.pdf](http://www.esma.europa.eu/system/files/esma-2014-799_irs_-_consultation_paper_on_the_clearing_obligation_no_1_.pdf) and <http://www.esma.europa.eu/system/files/2014-800.pdf>.

<sup>3</sup> The RTS are being prepared in accordance with the requirement under Article 5(2) of EMIR, to specify information including which classes of OTC derivatives should be centrally cleared and the dates from which that obligation should take effect.

## Covered Bond Derivatives

In the covered bond market, derivatives are used primarily to hedge exposures to underlying volatility in interest rates and foreign exchange. Such exposures might arise, for example, because of mismatches in the rate of interest being paid on (or currency of) the cover pool, as compared with the covered bonds themselves.

There are a number of unique features applicable to covered bond swaps which differ from more standardised trades, which potentially make them unsuitable for central clearing. In particular, covered bond derivatives are in most cases subject to one-way collateralisation, whereby the counterparty is required to post collateral, while the covered bond issuer is not. Indeed, in many cases, the cover pool may not comprise eligible collateral that could be posted to a CCP. Since the covered bond issuer's counterparty usually has a preferential claim on the cover pool and ranks *pari passu* with the covered bond holders, the need for it to receive collateral is ordinarily removed, on the basis that counterparty risk has already been mitigated.

Other non-standard features may also be present in covered bond swaps. These include circumstances where the notional principal amount adjusts on a periodic basis, such that it matches either the outstanding balance of the cover pool or the outstanding amount of a covered bond, over time ("balance guaranteed swaps"). Some covered bond swaps may also reference non-standard rates, such as the weighted average rate of mortgages contained in a particular cover pool. In addition, since covered bonds are rated, the ratings methodologies can often require the inclusion of ratings-linked thresholds and triggers, the disapplication of insolvency events and ratings-linked collateral volatility buffers.

To further complicate matters, the IR Consultation highlights the potential difficulty that CCPs might face in attempting to distinguish between the derivatives of the cover pool and those of the covered bond issuer. Covered bond derivatives are in most cases designed to survive the insolvency of the issuer. This means that if the issuer were to become insolvent, the source of payment would switch to the cover pool and the swaps would continue to mitigate interest rate and currency risks inherent in the covered bond structure. Indeed, this survival feature is usually mandated by applicable covered bond legislation. To the extent that a covered bond derivative was to be centrally cleared and the issuer was to become insolvent, the default rules of the CCP could result in an automatic close-out of the trade, in contravention of the survival requirement.

## The Proposal

Each of the Consultations has been prepared on the basis of what EMIR describes as the 'bottom-up' approach. In other words, the classes of derivatives which are to be considered eligible for clearing are those which are currently already being cleared by CCPs that are authorised or recognised under EMIR<sup>4</sup>. In respect of interest rate derivatives, these are proposed to include certain specified product types, such as fixed/ floating interest rate swaps, basis swaps, forward rate agreements, overnight index swaps and interest rate options. Each product type can then be further narrowed down and defined in accordance with specified characteristics, such as the settlement currency or floating reference rate, etc.

In respect of any of these types of derivatives which relate to covered bonds, ESMA accepts that (for reasons including those described in more detail above) in a number of cases, such transactions will not be suitable for clearing. However, it also believes that there may be certain trades which are standard enough to be captured by the interest rate classes identified in the IR Consultation.

In its July 2013 Discussion Paper, ESMA proposed two possible approaches to the central clearing of covered bond derivatives:

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<sup>4</sup> [http://www.esma.europa.eu/system/files/ccps\\_authorised\\_under\\_emir.pdf](http://www.esma.europa.eu/system/files/ccps_authorised_under_emir.pdf).

**Option A** – Define a cover pool as a distinct category of counterparty under EMIR. This category could then be subject to a phase-in of the clearing obligation, therefore providing a temporary exemption in order to develop other solutions. This option garnered very little support from the covered bond industry, not least because of the inherent difficulties in defining the applicable cover pool category. ESMA has therefore confirmed in the IR Consultation that it shall not be taking this approach.

**Option B** – Consider that covered bond derivatives belong to separate classes of derivatives which should not be subject to the clearing obligation. ESMA generally favours this approach, subject to the applicable covered bond derivatives satisfying certain pre-determined conditions. These conditions are not dissimilar to those contained in the proposed RTS on risk-management techniques for non-centrally cleared derivatives (i.e., collateralisation of transactions)<sup>5</sup> and are set out further below.

### Covered Bond Exemption Conditions

The draft RTS contained in the IR Consultation proposes that OTC derivatives that are associated with covered bond programmes shall not be subject to the clearing requirement, *provided* that they satisfy the following conditions (each of which either identifies the transaction as a type which, as described above, is unsuitable for clearing, or supports the view that such transaction poses minimal systemic risk):

- a) they must not be terminated in circumstances where the covered bond issuer is in default (i.e., the survival feature referred to above must be a component part of the transaction);
- b) the derivative counterparty must rank at least *pari passu* with the covered bond holders;
- c) the transactions must be registered in the cover pool of the covered bond programme and in accordance with national covered bond legislation;
- d) they must only be used to hedge interest rate or currency mismatches vis-à-vis the cover pool;
- e) the covered bond programme they are associated with must meet the requirements of Article 129 of Regulation (EC) No. 575/213 (which focuses on the capital treatment of covered bonds under the Capital Requirements Regulation); and
- f) the covered bond programme they are associated with must be subject to a legal collateralisation requirement of at least 102%.

In our view, it is clear from the detail set out above that a number of issues remain to be determined. In particular, the requirement that transactions be registered in the cover pool of the covered bond programme requires further clarification. What exactly does 'registered' mean in this context? If, as in the case of the UK, there are formal legislative requirements to keep a record of each asset contained in the cover pool<sup>6</sup>, would the maintenance of such records be sufficient to constitute registration for this purpose? It remains questionable how the criteria can be satisfied in cases where there is no formal registration requirement. Moreover, does this requirement mean that the clearing exemption only applies to covered bonds issued in accordance with national covered bond legislation? If so, this will make it extremely difficult for structured covered bonds to be issued outside of a legislative framework and result in a stifling of innovation that should not be the objective of the legislation resulting from the IR Consultation.

<sup>5</sup> <http://www.mofo.com/~media/Files/ClientAlert/140512EMIR.pdf>.

<sup>6</sup> Paragraph 17 of The Regulated Covered Bonds Regulations 2008 (SI 2008/346).

## Implementation

The IR Consultation remained open for comments until August 18, 2014 and a number of responses have now been published.<sup>7</sup>

Following completion of the consultation and further discussions with the European System of Central Banks, in accordance with the procedure set forth in Article (5) of EMIR, the revised draft technical standards shall be submitted to the European Commission for endorsement.

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<sup>7</sup> <http://www.esma.europa.eu/consultation/Consultation-paper-Clearing-Obligation-no1-IRS>.