Financial institutions: capital requirements for the trading book and for re-securitisations; supervisory review of remuneration policies

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EUROPEAN CENTRAL BANK OPINION on a proposal for a Directive of the European Parliament and of the Council amending Directives 2006/48/EC and 2006/49/EC as regards capital requirements for the trading book and for re- securitisations, and the supervisory review of remuneration policies.

On 12 November 2009, the European Central Bank (ECB) issued an opinion on the abovementioned proposal for a Directive (*please refer to the summary dated 12/11/2009*). On 7 July 2010, the European Parliament adopted the proposed directive, which is now subject to the Council of the European Union's formal adoption. This opinion is based on the version of the proposed directive adopted by the European Parliament.

The ECB is concerned about the **extension of the waiver for exposures in the form of covered bonds, collateralised by loans secured by residential and commercial real estate**, contained in Annex I, paragraph 2(c)(ii) to the proposed directive. The extension of the waiver from 31 December 2010 to 31 December 2013 allows unlimited use of senior units issued by securitisation entities securitising residential and commercial real estate exposures in the cover pool of covered bonds. Moreover, the adopted text removes the reference to the most favourable credit quality required for these units.

The proposed directive, thus, affects UCITS-compliant covered bonds and asset-backed securities (ABSs) eligible for Eurosystem credit operations, as laid down in Guideline ECB/2000/7 of 31 August 2000 on monetary policy instruments and procedures of the Eurosystem. In this respect, the Eurosystem's collateral framework imposes a stricter treatment from a risk management perspective, e.g. higher haircuts and rating requirements, on ABSs compared to UCITS-compliant covered bonds. A possible consequence of the proposed directive could be to provide strong incentives for monetary policy counterparties to package their ABSs into the cover pool of such covered bonds, thereby obtaining more favourable treatment, to the detriment of the Eurosystem's risk exposure.

At the same time, and without prejudice to the ECB welcoming regulatory steps which mitigate the reliance of legislation on external ratings, the ECB has some concerns about the **removal of the reference to the most favourable credit quality required for these units**, as this could further undermine the credibility and transparency of the covered bonds market and, ultimately, have consequences for financial stability.

In general, the aim for the regulators in the near future should be to remove the waiver and develop a rigorous set of criteria for assets to be included in the cover pool of covered bonds which: (i) does not rely on external ratings; and (ii) is strong enough to secure market confidence in covered bonds, while allowing financial institutions sufficient time to adjust their respective business models. The reduction of the limit of the nominal amount of the outstanding issue from 20% to 10%, contained in Annex I, paragraph 2(c)(i) and (ii) to the proposed directive, can be seen as a positive movement in this direction.