VDP’s Hagen speaks out

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The VDP’s newly appointed president, Dr Louis Hagen, has some strong, clear cut views on a wide range of topics affecting both the Pfandbrief and covered bond markets. He talks to The Cover about the implications of Brexit, covered bond supervision in the banking union, the Net Stable Funding Ratio, the leverage ratio, soft bullet extensions and harmonisation.

The Cover: What does the UK referendum result mean for the VDP / covered bonds?

Dr Louis Hagen, president of the VDP: It’s a result that most probably won’t have any positive effect on the banking industry or on the covered bond market as a whole. Uncertainty about the future nature of UK-EU relations is not good for anyone. If anything Pfandbrief should benefit from its flight to safety appeal.

Yet the answer to what will happen to UK cover assets in Pfandbrief cover pools is clear: For the time being they remain eligible assets. UK assets will not become ineligible until the UK has formally left the European Union which will be two years after signing Article 50. Within that timeframe it will be possible to change the Pfandbrief Act and allow UK assets to become eligible for the cover pools in line with EU cover assets.

The Cover: What is your declaration of intention?

Hagen: Pfandbrief issuers used to be a relatively small group of banks with similar interests but we now have a much more heterogeneous group with different interests. So, in a way, it’s more challenging to find the common interest. For the traditional Pfandbrief issuers, Pfandbrief remains the most important source of funding. But then you also have the universal banks for which Pfandbrief is one of many funding tools. I think the common ground is that both must trust in Pfandbrief remaining a top quality instrument on which they can always rely on.

And in the context of rates becoming increasingly negative, Pfandbrief should become more important. On the liability side of the banks’ balance sheet deposits are becoming more short-term but on the asset side loans are becoming progressively more long-term.

This presents an unwelcome maturity mismatch, which makes it more important than ever to have a sustainable source of long term funding. So I think Pfandbriefe will become even more attractive for issuers. The task of the vdp is to ensure Pfandbriefe maintain their stamp of high quality and that EU regulation continues to grant privileges. That’s the declaration of intention, it’s not a big change!

The Cover: Who is the supervisor of Pfandbriefbanks? Can you talk about the complexity and possible conflict of covered bonds in banking union?

Hagen: It’s a complex question. It is true, there is a degree of conflict of interest between national and supranational supervisors. There are 21 members of the vdp that are supervised directly by the ECB. But when it comes to Pfandbrief they are specifically supervised by the

national supervisor which is BaFin. BaFin is there to make sure all issuers operate in a proper and legal way and the best way to do that is to protect the Pfandbrief holders.

The ECB and other regulators are however more concerned with the entire bank and all of its creditors. So that may give rise to potential antagonism. The rules on bank resolution and those on protecting Pfandbrief holders before and after the insolvency of a bank must be properly aligned to ensure there will be no such antagonism. Ultimately, Pfandbrief holders must be protected which is why the bonds get preferential regulatory treatment.

This is particularly important in the context of the Bank Recovery and Resolution Directive. In the past a bank was either solvent or insolvent, so you had a clear line. Today we have three situations. A solvent, going-concern bank with full responsibility for the management of the cover pools where the rules are very clear. And then of course when it comes to a bank's insolvency the law is also very clear. But now we have this potential situation where you have a problem bank, a situation not foreseen in the Pfandbrief Act, for which there is no regulation.

The rules are there to protect the Pfandbrief holders but some see room for interpretation. A regulator could judge that the bank is in a difficult situation, draw up a plan to resolve the problem and ask why the Pfandbrief holders should not take part in the bank's recovery over this period. The positive aspect is the "no creditor worse off" principle stipulated in the BRRD. It means that no investor should be treated worse in resolution than in issuers insolvency. Nevertheless, we should look at the Pfandbrief Act and see whether the rules are clear about what should happen to Pfandbrief holders during such a period of elevated uncertainty.

The Cover: Why should the covered bond community be concerned about the current proposal for Net Stable Funding Ratio?

Hagen: I do not understand why cover pool mortgages should require 100% net stable funding when mortgages outside the cover pool should require less stable funding. There doesn't seem to be any logic behind that. We think that mortgages should require identical stable funding regardless of whether they are part of the cover pool or not. We also think covered bonds with a maturity of less than six months should be counted as available stable funding. In general, the Net Stable Funding Ratio should favour covered bonds which provide the cheapest most reliable source of long term funding.

The Cover: Does the leverage ratio give cause for concern?

Hagen: Banks issuing covered bonds have different compositions of their balance sheet and this means the leverage ratio impacts their business differently. For example, if you have a universal bank involved in the SME sector, they will have a capital requirement this is likely to be high enough to comply with the 3% leverage ratio.

But if it's a bank like Muenchener Hypothekenbank which has most of the balance sheet composed of residential mortgage loans, the capital requirement is lower as is the risk of default. Also, a bank that's active in public sector lending has a lower capital requirement and they may have difficulties complying with the 3% ratio. So, in my opinion, the leverage ratio should be determined on a case-by-case basis.

The implementation of Basel II moved towards a more risk sensitive approach and in general rating based approaches were implemented and the standardised approach was much more differentiated. I believe the leverage ratio takes regulation back to a time before Basel II was implemented. This comes on top of an excessive revision of credit measurement standards referred to as Basel IV that suggest some of the loans on the balance sheet should not be applicable for the Internal Ratings Based approach and the introduction of a new IRB floor that will lead to much higher capital requirements.

Going back is not always wrong, but in this case I believe it's more important to follow a risk sensitive approach to capital requirements. The proposed leverage ratio hits everyone, no matter whether its justified or not. Instead, banks should be individually assessed by their supervisors

The question is not about whether it's possible to raise capital the question is whether a bank is able to provide a decent return on the additional capital. With a low risk business model revenues are of course more limited than for a bank with higher risk assets on its balance sheet. This means the 3% leverage ratio, which is supposed to be a backstop, turns out to be more like a game-changer for those banks with low risk business models.

They must discontinue business because either they will have to find higher yielding, riskier business, which neither banks nor supervisors want, or they will have to cut their business down to a level that makes them comply with the 3% leverage ratio. But if they do that they won't necessarily have enough assets on their balance sheet to earn enough to pay their owners — which is of course unacceptable for them.

I am afraid the entire approach advocated in the Capital Requirement Regulation whereby EBA shall analyse whether specific business models justify different levels of leverage ratio is wrong. It is impossible to generally define comparable business models across Europe.

This can only be done by looking at each bank individually. We have SREP, the Supervisory Review and Evaluation Process, which was implemented about 2 years ago. Via the SREP supervisors look deeply into the risks and business model of each bank. So the supervisors should be able to have enough information to decide on an individual basis which leverage ratio is correct as they do for the pillar 2 capital requirement.

The Cover: Why is the maturity extension being proposed in Germany? In what ways does the German proposal for a one-year maturity extension differ from the rest of the market?

Hagen: Maturity extension has been proposed because we believe it helps to protect Pfandbrief holders as ultima ratio of the cover pool administrator. It can help overcome a potential situation where liquidity is short and cover pool assets must be sold to meet payment obligations which in a fire sale situation could come at a loss for Pfandbrief holders as asset prices might be very low.

We initially opposed the idea, even though hard bullet maturities require greater overcollateralization, because we thought investors wanted to be certain of the maturity without exception. But we now see soft bullets have been implemented in many jurisdictions and our concerns don't seem to matter so much.

The difference between the German proposal and others is that we are looking to implement a statutory maturity extension via the Pfandbrief Act which comprises outstanding as well as future issues. It's important for Pfandbrief to be a homogenous market which is why we think it should be implemented by law.

We also envisage having a six months extension period initially which can be renewed by the cover pool administrator for another six months if he needs more time, but that's it. So German maturity extension might be shorter than the one year you usually have in most other soft bullet agreements.

The Cover: Why should the covered bond community care about harmonisation?

Hagen: I remember the times when you had just German, Danish and French covered bonds and that was more or less it. Now of course having seen the great success of covered bonds worldwide we have a much more diverse picture of this community. It may already have become somehow too diverse.

First of all, we don't really have a proper definition of what a covered bond is. CRR requires more prerequsisites than UCITS does but it is still very open-ended. So we have seen some convergence through CRR, but I don't think it's enough. If you look at the privileges that covered bonds have in different regulations, some might question whether they are justified if there are not enough rules defining what the product really is. To keep or extend these privileges it is necessary to have some level of harmonisation which should be principles-based.

Competition between the various jurisdictions is good and investors like it because they have the possibility to diversify. Even though Pfandbrief is among the most prestigious and traditional products we think harmonisation is necessary, too, because we think it is unrealistic to achieve a special treatment for Pfandbrief only. Pfandbrief is a part of the covered bond community,as such we at vdp get very much involved in these discussions as we think they will benefit covered bond markets as a whole.

The Cover: What are the easy wins - in terms of progressing with harmonisation?

Hagen: Transparency should be an easy win. More granular disclosure of the cover pools and of the liability structure of the bank may be helpful, and the definition of cover assets should be rather easy to agree on, too. The next step is special public supervision which I believe has always been a quality hallmark of the Pfandbrief. As I see it this is something which is very different in different countries, so this is something which should be looked into. Then you have investor protection — though I believe it is more complicated to find common rules that fit into different national insolvency regimes. It's important to ensure investors are protected no matter what state the bank is in — whether it's healthy, insolvent or in the process of being wound down.

This level of harmonisation would still leave enough room for different covered bond models to compete for the best prices with investors.

The Cover: In Germany all senior bonds can be impaired, but is this approach optimal for investors / issuers? What are the risks to this approach?

Hagen: Just to clarify, according to BRRD all unsecured bonds can be impaired. This is a very clear approach taken by the German legislator. Germany doesn't favour too many different levels of prioritised debt. For the time being we are happy with that, though we are not happy that the ECB has not yet stated publicly whether German senior bonds are still eligible for ECB open market operations.

The Cover: Is there room for covered bond issuers to consider other MREL alternatives (such as issuing contractually bail-in-able debt as recently offered by Nykredit, or other alternatives)?

Hagen: We have been looking closely at what other banks have been doing such as those in France, or Nykredit in Denmark, but we have not made any formal decision yet. A proper economic assessment has to be made yet, but so far we have shied away from issuing new kinds of subordinate debt.

If the market prices correctly, then the weighted-average cost of funding across the liability structure should be broadly similar no matter what the proportional mix of subordinate to senior debt is for a given bank. But of course you never really know whether the market is pricing correctly. For the time being it doesn't look like we will go down the same path as the French or Nykredit, but things might change.