EBA/Op/2023/15

8 January 2024

Opinion of the European Banking Authority on a decision to grant the permission referred to in Article 129(1), point (c)(ii) and Article 129(1a), point (c), of the CRR – notification from Bank of Italy

Introduction and legal basis

1. Article 129 of Regulation (EU) No 575/2013 of the European Parliament and of the Council[1] (CRR), as amended by Regulation (EU) 2019/2160 of the European Parliament and of the Council[2] (CBR), specifies the conditions that covered bonds shall meet to receive preferential treatment under the prudential framework, and identifies eligible assets that can be used as collateral of those covered bonds.

2. In particular, Article 129(1), point (c), of the CRR specifies that eligible covered bonds can be collateralised by exposures to credit institutions that qualify for credit quality step (CQS) 1 or CQS 2 as specified in Part Three, Title II, Chapter 2 of the CRR. Exposures to institutions that qualify for CQS 3 are allowed to back eligible covered bonds only where those exposures are in the form of: (i) short-term deposits with an original maturity not exceeding 100 days, where used to meet the cover pool liquidity buffer requirement set forth in Article 16 of Directive (EU) 2019/2162 of the European Parliament and of the Council[3] (CBD); or (ii) derivative contracts that meet the requirements of Article 11(1) of the CBD, where permitted by the competent authorities.

[1] Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26.6. 2013 on prudential requirements for credit institutions and amending Regulation (EU) No 648/2012 (OJ L 176, 27.6.2013, p. 1).

[2] Regulation (EU) 2019/2160 of the European Parliament and of the Council of 27.11.2019 amending Regulation (EU) 575/2013 as regards exposures in the form of covered bonds (OJ L 328, 18.12.2019, p. 1-6).

[3] Directive (EU) 2019/2162 of the European Parliament and of the Council of 27 November 2019 on the issue of covered bonds and covered bond public supervision and amending Directives 2009/65/EC and 2014/59/EU (OJ L 328, 18.12.2019, p. 29).

3. Article 129(1a), point (c), of the CRR specifies that the competent authorities designated pursuant to Article 18(2) of the CBD may, after consulting the EBA, allow exposures to CQS 3 credit institutions in the form of derivative contracts to be used as eligible collateral, provided that significant potential concentration problems in the Member States concerned due to the application of CQS 1 and CQS 2 requirements can be documented. In any case, pursuant to Article 129(1a), point (c), of the CRR, exposures to CQS 3 credit institutions in the form of short-term deposits or derivative contracts must not exceed 8% of the nominal amount of outstanding covered bonds of the issuing credit institution.

4. On 27 January 2023, the Bank of Italy, acting in its capacity of competent authority designated in Italy for covered bond supervision pursuant to the CBD, consulted the EBA on the exercise of the discretion set forth in Article 129(1a), point (c), of the CRR.

5. The EBA competence to deliver this opinion is based on Article 29(1), point (a), of Regulation (EU) No 1093/2010 of the European Parliament and of the Council[4] (EBA Founding Regulation), and Article 129(1a), point (c), of the CRR, as amended by the CBR, which relates to the EBA's area of competence referred to in Article 1(2) of the EBA Founding Regulation. This opinion has been drafted on the assumption that the information provided to the EBA is correct and that the national framework is aligned with the applicable EU law.

6. In accordance with Article 14(5) of its Rules of Procedure,[5] the EBA's Board of Supervisors has adopted this opinion.

General comments

Having given consideration to:

i. the evidence provided by the Bank of Italy on the current classification of Italian credit institutions in relation to the CQSs assigned on the basis of external credit ratings, whereby only one Italian credit institution and three branches of credit institutions established in other EU Member States currently classify as CQS 2;

ii. the evidence provided by the Bank of Italy on the current composition of the Italian covered bond market and on the characteristics of the Italian covered bond regime;

iii. the evidence provided by the Bank of Italy on the type and nature of exposures to institutions that covered bonds regularly assume;

the EBA is of the opinion that the Bank of Italy has provided sufficient evidence to document a significant potential concentration problem in Italy stemming from the application of the CQS 1 and CQS 2 requirement specified in Article 129(1), point (c), of the CRR. This has the potential to result in prudential concerns and concerns related to the degree of competition in the financial

[4] Regulation (EU) No 1093/2010 of the European Parliament and of the Council of 24.11.2010 establishing a European Supervisory Authority (European Banking Authority) amending Decision No 716/2009/EC and repealing Commission Decision 2009/78/EC (OJ L 331, 15.12.2010, p. 12).

[5] Decision adopting the Rules of Procedure of the European Banking Authority Board of Supervisors of 11.12.2013 (Decision EBA/DC/001 (Rev 3)).

market. The EBA is therefore of the opinion that the exercise of the discretion is adequately justified.

Specific comments

Assessing a significant potential concentration problem

7. The EBA assesses the significant potential concentration problem within the jurisdiction of the Competent Authority that is notifying its intention to exercise the discretion referred to in Article 129(1a), point (c), of the CRR taking into account several factors, including the following:
    a. the nature and magnitude of exposures of national covered bond programmes to institutions that operate in that jurisdiction, also through branches, and existing exposures to non-domestic institutions, if any;
    b. the number of credit institutions to which a CQS 1 or CQS 2 is being assigned by any of the External Rating Agencies registered with or certified by ESMA (at least by any of the large/internationally active ECAIs);
    c. the scope of business activities of those credit institutions to which a CQS 1 or CQS 2 is being assigned;
    d. other potential specific considerations related to the institutions in that jurisdiction;
    e. potential additional eligibility conditions set by the national covered bond regime on exposures to credit institutions, beyond the CQS 1/CQS 2 criterion;
    f. an assessment of the expected impact of the discretion within that jurisdiction;
    g. other general considerations, where appropriate.

8. In order to determine compliance with Article 129(1a) of the CRR, the EBA considers several different forms of exposures to institutions that may arise within a covered bond programme, including but not limited to the following forms of exposures:
    a. exposures arising from the use of account bank facilities;
    b. exposures arising from derivative contracts entered into with institutions, i.e. where the institution is the counterparty of the covered bond issuer/covered bond programme within the derivative contract;
    c. exposures arising from the use of instruments issued by institutions as substitution/complementary assets within the covered bond programme;
    d. exposures arising from the use of liquidity facilities.

The concentration problem in Italy

9. Based on the evidence provided by the Bank of Italy, the Italian covered bond market amounts to € 114 bn (nominal amount of outstanding covered bonds) and comprises 22 programmes

by the following 14 issuing banks[6]: BNL SpA; MPS SpA; Unicredit SpA; Credem SpA; Intesa Sanpaolo SpA; Deutsche Bank SpA; Banco Desio e della Brianza SpA; BPM SpA; BPER SpA; Banca Popolare di Sondrio SpA; Banca Popolare dell'Alto Adige SpA; Banca Carige SpA; Credit Agricole Italia SpA; Mediobanca SpA.

10. As regards the size of collateral assets, the total cover pools for Italian covered bonds amount to € 216 bn.[7] Reported exposures in derivative assets and liabilities in the cover pool amount to € 2.3 bn in terms of absolute - i.e. assets and liabilities - market value.[8-9] Derivatives are currently used in covered bond programmes mainly to hedge interest rate risk and, to a limited extent, currency risk (as the majority of the issued covered bonds and cover assets are Euro denominated).[10]

11. As regards the credit rating of Italian banks, out of 23 Italian banks with available long-term credit ratings, none of them has an external credit rating qualifying for CQS 1, while only BNL SpA has an external long-term credit rating qualifying for CQS 2 (see also Table 1 below). It is to be noted that BNL, which qualifies for CQS 2, is part of the French banking group BNP Paribas, while, generally, the credit rating of Italian banks/groups is capped by the country ceiling of Italian sovereign debt rating (i.e. BBB according to S&P's and Fitch, Baa3 for Moody's, which corresponds to CQS 3).

Table 1 – Italian credit institutions with long term credit rating and corresponding credit quality step (as of June 2022)

Banca	Best LT rating	Credit quality step
Banca Akros SpA	BBB (DBRS)	3
Banca Carige SpA	B (DBRS)	5
Banca IFIS S.p.A.	Baa3 (Moody's)	3
Banca Monte dei Paschi di Siena SpA	B (Fitch)	5
Banca Nazionale del Lavoro SpA	A (DBRS)	2
Banca Popolare dell'Alto Adige Volksbank SpA	BBB (DBRS)	3
Banca Popolare dell'Emilia Romagna S.C.	Ba3 (Moody's)	4
Banca Popolare di Sondrio SpA	BBB (DBRS)	3
Banca Sella SpA	BBB (DBRS)	3
Banco BPM SpA	BBB (DBRS)	3
BFF Bank SpA	Ba2 (Moody's)	4
Cassa Centrale Raiffeisen SpA	Baa2 (Moody's)	3

[6] Data as of 31 December 2021, source COREP – asset encumbrance reporting (source "*ECBC Factbook 2022*" as regards the number of programmes). As of September 2022, the nominal amount of outstanding covered bonds amounted to ~ € 115 bn.

[7] Data as of 31 December 2021, source FINREP (carrying amount).

[8] Reporting absolute market values seems to be more appropriate for this purpose compared to (only) asset value, as it gives a clearer idea of the size of the positions and the corresponding risk covered. Indeed the value of hedging derivatives changes over time (and might become positive or negative) and alternative measures – as asset size or assets minus liabilities – might underestimate the underlying risk covered by hedging derivatives.

[9] As of 31 December 2021, six banks reported derivatives in the cover pool varying from a minimum amount of € 29 mln to a maximum of € 783 mln.

[10] As of 31 December 2020, all Italian covered bonds outstanding were denominated in Euro (source ECBC – European Covered Bond Fact Book 2021).

Dexia Crediop SpA	BBB (S&P)	3
FCA Bank SpA	BBB (S&P)	3
Fideuram - Intesa Sanpaolo Private Banking SpA	BBB (S&P)	3
FinecoBank SpA	BBB (S&P)	3
Iccrea Banca SpA	BB (DBRS)	4
Intesa Sanpaolo SpA	BBB (S&P)	3
Istituto per il Credito Sportivo	BBB (DBRS)	3
Mediobanca SpA	BBB (S&P)	3
MedioCredito Centrale SpA	BBB- (S&P)	3
Mediocredito Trentino-Alto Adige SpA	Ba1 (Moody's)	4
UniCredit SpA	BBB (S&P)	3

12. According to the data above provided by the Bank of Italy, should the discretion not be exercised, BNL would represent the only Italian-based legal entity eligible as a derivative counterparty for Italian covered bond issuers. This may negatively affect the market efficiency in terms of costs, volumes and market continuity.

13. It should also be taken into account that, according to the CBR, assets eligible as covered bond collateral can include short-term deposits and hedging derivatives to credit institutions that qualify for credit quality step 3 up to a cap equal to 8% of the nominal amount of the outstanding covered bonds of the issuing credit institution. Given that the Italian covered bond market amounts to € 114 bn, the cap is equal to approximately € 9 bn. Even if short-term deposits can be used as well, relying on a single legal entity as hedging derivatives counterparty could potentially undermine an efficient use of this cap, limiting the recourse to hedging strategies that can be easily performed through derivatives (e.g. IRS). It should also be noted that BNL currently does not contribute to the aggregated € 2.3 bn of derivatives exposures mentioned above.

14. Lastly, relying on a single legal entity as a hedging derivatives counterparty could create an undesirable impact in terms of risk exposure at the level of that counterparty, which may also impact the covered bond market. Assuming that BNL would be willing to enter into derivative contracts to hedge the risks of covered bond programmes, it would be bound by the need to comply with prudential requirements and limits (in particular, the large exposure limits). Therefore, a single legal entity may not be able to act as a hedging derivative counterparty for all Italian programmes, with a negative impact on the covered bonds market.

15. The EBA has additionally assessed whether branches of non-Italian credit institutions established in other EU Members States and operating in Italy could act as eligible derivative counterparties. Table 2 provides information on the branches of credit institutions established in other EU Member States operating in Italy with an external credit rating.

16. As depicted in table 2, there are four branches with external rating qualifying for CQS above 3. It should be noted that two of these branches are part of the same group of BNL Spa (the only Italian-based legal entity having the required rating as mentioned above), and can be therefore considered as a single counterparty, as they are all bound by the same prudential restriction at

the consolidated level. In addition, there currently seem to be no indications that these three banks would be able or have willingness to provide services as derivative counterparties. In this respect, it should be considered that branches have a reduced operating capacity compared to banks.

Table 2 –Credit institutions established in other EU Member States operating in Italy via branch with available long term credit rating (as of June 2022)

Banca	Best LT rating	Credit quality step
Barclays Bank Ireland PLC (Milan Branch)	A (S&P)	2
BNP Paribas SA (Milan Branch)	A+ (S&P)	2
BNP Paribas Securities Services (Milan Branch)	A+ (S&P)	2
Deutsche Bank AG (Milan Branch)	A- (S&P)	2
Dexia Crediop SpA	BBB (S&P)	3
FCA Bank SpA	BBB (S&P)	3

17. The EBA has also assessed whether there are already existing exposures from derivative contracts assumed by covered bonds to non-domestic counterparties (i.e. established in other member states or third countries). According to the information provided by the Bank of Italy, currently there is only one existing case of non-domestic derivative counterparty for which a coverage asset swap is in place. It should be noted, however, that it is a contract under decommission (expire date July 2024). Furthermore, from an operational standpoint, it should be noted that relying on non-domestic derivative counterparties for risk hedging in covered bond programmes is not a current market practice in Italy. Therefore, there is a risk that a sudden pressure towards a reliance on non-domestic counterparties may have an impact on the costs for the covered bonds programmes and hence the costs of funding for banks.

18. Taking into account:

    a. the documented size of the Italian covered bond market;

    b. the fact that, in accordance with Article 129 of the CRR, each issuing institution may collateralise with exposures to credit institutions up to 15% of its outstanding covered bonds,

the potential exposure of all Italian covered bond issuers to one eligible Italian credit institution, three branches of credit institutions established in other EU Member States and operating in Italy, and one foreign derivative counterparty as eligible hedging derivatives counterparties is, in the view of the EBA, likely to result in an excessive concentration and, consequently, to pose both prudential concerns and concerns related to the degree of competition in the Italian financial market.

Exercise of the discretion

19. The EBA understands that the CBD has been transposed into the Italian regulatory framework through Legislative Decree No 190/2021, which amended Law No 130/1999 on securitisations and covered bonds. The Bank of Italy has amended its Circular No 285/2013 (Supervisory Provisions for banks[11]) to complement the covered bonds framework. The amendments have been subject to public consultation[12] and have been adopted on 30 March 2023. The EBA takes note that, by means of such provisions, the Bank of Italy exercised the discretion set forth under Article 129(1a), point (c), of the CRR, thus allowing for the eligibility of exposures in the form of eligible derivative contracts to institutions that qualify for CQS 3 (see under Part Three, Chapter 3, Section 3, paragraph 1.2 of the Circular No 285/2013).

Review of the permission's continued relevance

20. The amendment to Circular No 285/2013 allows derivatives whose counterparties qualify at least for CQS 3 to be included in the collateral pools of covered bonds. The Bank of Italy declared in the formal act of adoption of the amendments to the Circular No. 285/2013 (the so called "Atto di emanazione") that it considers reassessing its decision taking into account the view expressed by the EBA. Following the EBA's opinion, the Bank of Italy intends also to review on a regular basis the conditions for maintaining the waiver.

21. Should the Bank of Italy verify that, in the future, concentration problems disappear, an amendment to the provisions of the Circular would be required to exclude the admissibility of derivatives whose counterparties qualify for CQS 3 to the collateral pools of covered bonds. The amendment would then also indicate what the consequences would be with respect to existing derivatives entered into with CQS 3 counterparties. In this respect, the need for a specific grandfathering regime, as well as its features (including its length and conditions), would be assessed in due time, also depending on the expected impact that this amendment would have on existing covered bond programmes.

22. This opinion will be published on the EBA's website.

Done at Paris, 8 January 2024

[signed]

José Manuel Campa

Chairperson
For the Board of Supervisors

[11] Available at the following website: https://www.bancaditalia.it/compiti/vigilanza/normativa/archivio-norme/circolari/c285/?dotcache=refresh

[12] Available at the following website: https://www.bancaditalia.it/compiti/vigilanza/normativa/consultazioni/2023/obbligaz-banc-garantite/index.html.