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Oggetto: Consultation on changes to rules for OBG issuers
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Dear Sir,

I am writing with some observations in response to the consultation on amendments to the supervisory provisions of the OBG act.

Benefits of proposal
It is clear that covered bonds benefit both the issuing bank and society as a whole so, prima facie it would seem beneficial to make the funding instrument as widely available as possible.

- **Competitive disadvantage**

Furthermore, the current rule creates a competitive disadvantage for the smaller banks and could be argued to be discriminatory. Rescinding the rule would help to ensure a 'level playing field'.

It could be argued that the nature of covered bonds as a funding tool is such that they necessarily favour larger banks. The upfront costs of issuance, the market's preference for larger, rather than smaller bond issues and the greater collateral efficiency for larger cover pools all make the funding tool more efficient the more one issues.

However, the costs of issuance – primarily legal and information technology and investment banking fees – tend to decrease over time and there is a vibrant, and growing, market for 'sub-benchmark' issues. We note that in mature covered bond markets such as Germany 79 banks issue covered bonds, the vast majority of them have never issued a benchmark sized transaction. This is a healthy exemplar for the potential benefits of widening the access to the funding tool.

It may be appropriate at this stage to explore ways in which the costs of covered bonds may be reduced for smaller banks including, for example, standardised documentation and IT platforms, pooling models and standardised conditional pass through terms (which would reduce the collateral inefficiencies of covered bonds for smaller banks).

Finally, whilst covered bonds are less efficient for smaller banks, a minimum size requirement is an arbitrary thing and whether a smaller bank actually uses the funding tool should be left to market forces rather than regulatory fiat.

- **Asset encumbrance**

Covered bonds are inherently more collateral efficient than both securitisations and the ABACO facility that are frequently used currently by Italian banks. To the extent that they are used as direct substitutes for these funding tools (either for the sale of bonds to the market or retained as collateral for repo operations), they will reduce the level of over-encumbrance in the banking system.

- **Access to funding**

One of the widely regarded benefits of the covered bond market is its ability to provide wholesale funding at times of market volatility – covered bond issuance increases in times of market stress often as the only available public funding tool to the bank's treasurer. With market volatility seemingly increasing for political and economic reasons this is an increasingly important feature of covered bonds. This is particularly true for smaller banks with, for example lower name recognition in the international markets and less ability to source intra-group liquidity from foreign subsidiaries.

- **Retail funding**

The EBA and ESMA recently expressed certain concerns about the extent of retail holdings of bonds that may be subject to bail-in. To the extent that these might be replaced by covered bonds targeted at retail investors, access to covered bonds may reduce this concern for smaller banks.

Furthermore, addressing the EBA and ESMA concerns by creating a very safe bond for retail distribution, covered bonds could contribute to the conversion of short term retail deposits to term funding for banks thus contributing to systemic stability.

Potential concerns

Presumably the introduction of the rule initially was to protect the quality of the Italian covered bond market, on the basis that smaller banks are either more likely to default or are perceived as more likely to default and that such concerns wold create a 'contagion' for the remainder of the market. I would dispute the fact that smaller banks are necessarily more likely to default. But, as no covered bond has ever defaulted the perception of the risk, ex ante, is the key point, not the actual default probability.

As such the existing rule has a signal effect: measures are in place that are unique to Italy that are designed to protect the good credit of the market. This is a strong signal. The perception that you are somehow 'loosening' credit standards with the change is a concern.

A way in which this perception may be addressed is a simultaneous 'renewal' of another rule designed to protect bond-holders – the limits on issuance dependent on capital ratios. When they were introduced these rules were regarded as an innovative and thoughtful way to ensure both minimum standards for covered bond issuance and a limit on encumbrance reliant on the credit of the issuer. However, as the perceptions of 'adequate' or 'high' levels of capital have recalibrated as a result of the financial crisis, the ratios in the existing rules could be seen to be out of date.

A recalibration of the capital ratios more in line with the existing capital levels of Italian banks, simultaneous with the removal of the €250mn rule would send a strong signal that the Bank of Italy remains a prudent supervisor of this product and that the changes in no way represent a loosening of standards.

I thank you for the opportunity to comment on the proposal and would be delighted to discuss it with you further if that would be useful.

With best regards,
Richard Kemmish

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