• **Dutch covered bond landscape to change**: We expect to see major changes in the landscape of Dutch covered bonds. The successful launch of the conditional pass-through covered bond (CPTCB) of Dutch bank NIBC provides an interesting new funding tool for issuers with a somewhat lower credit quality. Meanwhile, economic weakness has also resulted in weaker bank balance sheets, which in turn has made covered bonds a relatively more attractive funding tool for banks that have not yet issued regular covered bonds. What’s more, the fact that covered bonds are exempted from bail-in increases their attractiveness for investors as well as issuers.

• **Rabobank likely to join the regular covered bond market**: We expect that Rabobank will join ING and ABN AMRO on the regular covered bond market. It has also seen its rating being downgraded, while the weak Dutch economy is taking its toll on its balance sheet. Meanwhile, the bail-in discussion, the fact that asset encumbrance on Rabobank’s balance sheet is relatively low, the lower funding costs as well as a more diversified funding mix, are other strong arguments for Rabobank to enter the covered bond market. We estimate that the potential size of a covered bond programme could be up to EUR 70 bn, with the estimated price of a 5Y covered bond at around ms +5/10 bps and that of a 10Y covered bond at around ms +30 bps. This is markedly lower than recent issues of Rabobank senior unsecured debt as well as RMBS notes.

• **Achmea to start issuing CPTCBs soon**: We expect that Achmea Hypotheekbank will start issuing CPTCB in the near future. It has only one euro-denominated covered bond outstanding, which matures in February 2014. By then, we expect Achmea to switch its current programme into a pass-through structure. This will give it the advantage that the programme will be registered at the Dutch central bank (in contrast to its current programme), which will broaden its investor base. Meanwhile, funding cost will also be significantly lower than that of RMBS notes, as we estimate a 5Y CPTCB to be priced around ms + high 30s.

• **Van Lanschot also likely to enter pass-through market**: We expect that Van Lanschot will also join the CPTCB market, given the already mentioned benefits and the fact that it pays much attention to diversifying its funding mix. It has roughly the same amount of mortgages on its balance sheet as NIBC, but it has a stronger credit rating, so a 5Y CPTCB of Van Lanschot should price below that of NIBC (all else equal). We think that Van Lanschot will be in no hurry to enter the market, but if it does, next year seems most likely.

• **SNS Bank another pass-through candidate**: A CPTCB programme will be attractive for SNS Bank as well, but given that it still has four outstanding regular benchmark covered bonds, and that it will get a new credit rating once there is more clarity about its new structure, it is unlikely to switch in the near term. Although we think it will eventually be attractive to switch, we do not see this happening until late 2014 or beyond.
Introduction
The landscape of Dutch covered bonds is likely to change in the coming years. The successful launch of the conditional pass-through covered bond of Dutch bank NIBC could make such a structure an interesting new funding tool for issuers with a somewhat lower credit quality. Meanwhile, economic weakness has also resulted in weaker bank balance sheets, which, in turn, has made covered bonds a relatively more attractive funding tool for banks that have not yet issued covered bonds. Finally, the fact that covered bonds will most likely be exempted from bail-in will also increase their attractiveness as a funding tool compared to other funding sources. In the meantime, changes to the Dutch covered bond law, which are expected to be announced towards the end of the year, will probably also be supportive for the Dutch covered bond market. In contrast, asset encumbrance, the soft cap that the Dutch central bank applies to covered bond issuers, as well as the use of the Dutch Mortgage Institute as a new funding tool, are factors that make covered bonds less attractive. In this research note, we take a look at the future landscape of the Dutch covered bond market.

New structure paves way for new issuers
Newly structured covered bonds, and the conditional pass-through structure in particular, are likely to impact the future covered bond landscape, not only in the Netherlands, but also more generally. In this note, however, we focus on the Dutch market. The successful launch of the conditional pass-through covered bond (CPTCB) of NIBC Bank is likely to attract attention of other issuers as well. One of the key advantages of a CPTCB is that a higher credit rating is achieved, while issuers need to put less collateral aside. So, from an issuer perspective, there seem to be large benefits from a CPTCB, especially when taking into account current discussions about asset encumbrance and the fact that volatility of covered bond ratings have increased on the back of downgrades of issuers as well as sovereigns. As a result, a CPTCB increases access to the covered bond market of banks with a somewhat lower credit quality, providing not only cheaper funding, but also improving their funding diversification.

Dutch banks also faced rating downgrades
Looking at the rating developments of Dutch issuers, it follows that all large as well as smaller Dutch banks have faced downgrades of one or more notches in the past five years (see figure 1). Figure 2 shows that Rabobank currently has the highest bank credit rating in the Netherlands, followed by ING and ABN AMRO. Meanwhile, Van Lanschot, SNS Bank, and NIBC Bank close the ranks, with the latter two being just in the investment grade category.

New structure paves way for new issuers

So, looking at the quality of potential issuers, we expect that besides NIBC, SNS Bank as well as Van Lanschot might consider issuing CPTCBs, as they will not (or only just) be able to get a AAA rating for a regular covered bond programme.

SNS Bank not able to issue under current programme
In case of SNS Bank, the credit rating of its current regular covered bond programme has fallen to below the minimum level (AA-/Aa3) required by the Dutch central bank in order to be able to issue (new) covered bonds. It would however be able to issue covered bonds under a pass-through structure, given that such a programme will most get a AAA rating from the rating agencies. What’s more, SNS Bank’s loan-to-deposit
ratio, which is a good measure of the deposit funding gap that indicates the dependence on wholesale funding, stood at 138% in June, which is relatively high. Given that covered bonds take account of 7% of SNS Bank’s total funding, and bearing in mind its total refinancing needs (excluding interest) of around EUR 5 bn in 2014 and some EUR 3 bn in 2015 (Bloomberg data), we think that setting up a conditional pass-through programme is an interesting option for SNS Bank, especially as it will provide it with covered bonds with a relatively stable rating.

But SNS Bank still has four outstanding benchmarks…

However, SNS Bank has still four euro benchmark covered bonds outstanding, of which the latest will mature in 2020. This implies that it needs to construct a second cover pool, as the Dutch central bank does not allow regular covered bonds as well as CPTCBs to have recourse to the same cover pool. As a result, SNS Bank would need to buy back its current outstanding covered bonds, or otherwise decide that the current programme would become dormant, which will be a disadvantage for current investors in these bonds.

…while it awaits a new credit rating

Furthermore, it is likely that the credit rating of SNS Bank will be revised upwards when there is more clarity about its future structure. This will also result in a rating upgrade of its current covered bond programme, making it eligible again to issue new covered bonds. Although it remains questionable whether the covered bond programme will eventually get a AAA rating at both Moody’s and Fitch, the fact that the rating will be sufficient again to issue regular covered bonds, might induce the bank to prefer a wait-and-see stance rather than starting to set up a CPTCB programme.

Switch to pass-through attractive in long run

Finally, the setup of the Dutch Mortgage Institution (NHI) in order to finance part of the banks’ mortgage loans with a National Mortgage Guarantee (NHG) is likely to become another (cheap) source of funding for SNS Bank. So, instead of issuing CPTCBs, SNS Bank might decide to use the NHG as new funding tool, given that around 20% of its EUR 48 bn of residential mortgages have such a guarantee. Overall however, and looking at the longer term, we think that eventually it will be interesting for SNS Bank to switch its current covered bond programme into a conditional pass-through structure, as it provides the benefits of a high and stable rating against less collateral.

Van Lanschot likely to enter pass-through market…

Another bank that we expect to start setting up a CPTCB programme is Van Lanschot, which has around EUR 7 bn of mortgages on its balance sheet, compared to EUR 8bn of NIBC. So far, it has not yet issued any covered bonds, but this is likely to change given the benefits of a conditional pass-through structure, and bearing in mind that the bank pays much attention to the diversification of its funding mix.

…which would significantly lower its funding cost

In April of this year, Van Lanschot sold EUR 750 mn of RMBS notes at a price of 3 months Euribor +95bps and a maturity of 2.15 years. Recalculated over mid swap, we estimate the spread at roughly ms + low 80s. Given the price of NIBC’s CPTCB (ms +50 bps), and taking into account the 2 to 3 notch higher credit rating of Van Lanschot as well as the shorter maturity of the RMBS, it seems that CPTCBs of Van Lanschot will be sold at much lower levels than their RMBS notes.

At the time of writing, the outstanding 2.125% 08/30/17 covered bond of SNS Bank, which is a relatively good comparable to the RMBS given SNS Bank’s rating and residual maturity, was for instance trading at around ms + mid 30s. If we use this bond as a proxy for a CPTCB of Van Lanschot (and keeping in mind that Van Lanschot’s credit rating is one notch above that of SNS Bank), we estimate that a CPTCB of Van Lanschot will be priced at around ms + high 30s, half that of its RMBS. Furthermore, a 5Y CPTCB of Van Lanschot should be priced below that of NIBC (ms + 50 bps), given its stronger credit rating.

A regular programme also in reach for Van Lanschot, but less OC and more stable rating favours CPTCB

Also in case of Van Lanschot, there are some counter-arguments. First of all, the credit rating of the bank is above that of NIBC as well as SNS Bank. This implies that also a regular covered bond programme of Van Lanschot is likely to get a AAA rating, which would provide a more favourable pricing than CPTCBs. However, if it were to get a AAA rating, this would be rather vulnerable to issuer rating changes, as it is unlikely to have any rating buffer. This will be less in the case of a conditional pass-through structure. Admittedly, the bank could commit more overcollateralization (OC) in order to strengthen the rating of a regular covered bond, but this will come with a cost of higher asset encumbrance. Therefore, we believe that the fact that in a pass-through structure less OC is needed, while swaps are also not included, is likely to make it
Covered Bond Watch - Dutch market expected to change

a more interesting source of funding for Van Lanschot than a regular covered bond programme. In terms of timing, we think that Van Lanschot will be in no hurry to enter the market, but if it does, next year seems most likely.

Achmea to join NIBC in near term
Meanwhile, we expect Achmea Hypothekenbank (rated A- by Fitch and A at S&P) to start using CPTCBs as a new source of funding in the not too distant future. Achmea still has one euro denominated soft bullet covered bond of EUR 1.5 bn outstanding, which matures in February 2014. Overall, Achmea’s covered bond programme is not included in the covered bond register of the Dutch central bank, while it also is in sleeping mode. However, given the successful launch by NIBC, it is likely to construct a new cover pool in order to start issuing CPTCBs. Achmea Hypothekenbank has around EUR 12 bn of Dutch residential mortgages on its balance sheet and we expect it to switch from its current covered bond programme to a pass-through construction once the latest covered bond has matured. If it registers the programme at the Dutch central bank, an additional advantage is that it will provide more clarity and safety to investors, which we expect will broaden its investor base.

We estimate the price of a 5Y CPTCB at ms + 40 bps
In terms of pricing, we expect a 5Y CPTCB of Achmea Hypothekenbank to be priced at around ms + 40 bps, given that it has a much stronger rating than NIBC. This would be substantially lower than what Achmea had to pay in July for 5Y RMBS notes, which were priced at an equivalent of ms + mid 70s. As a result, issuing CPTCBs will significantly reduce Achmea’s funding costs.

Aegon and Delta Lloyd unlikely to join
Other financial institutions that might look at the issuance of CPTCBs are Aegon and Delta Lloyd. However, in contrast to Achmea Hypothekenbank, these institutions have less mortgages at the bank level\(^1\) (Aegon Bank had around EUR 4.5 bn of mortgages on its balance sheet at the end of 2012, while we estimate the amount at Delta Lloyd Bank at just above EUR 1 bn). For these institutions, it therefore seems not very attractive to come with a CPTCB programme, as the size of the programme will be very small, while more assets need to be set aside as well, especially compared to their RMBS programmes. Therefore, the benefit of lower funding costs will not compensate for the higher cost in term of OC (and encumbrance) as well as the cost of setting up a programme. Furthermore, these insurers have reported that the funding gap is also limited, which also makes them less dependent on wholesale funding.

Needless to say, we do not expect ING and ABN AMRO to switch to a conditional pass-through construction. They have already significant amounts of regular covered bonds outstanding, which also benefit from a solid AAA/Aaa rating. So switching to a new structure will only bring extra costs for these issuers, as the price of such bonds will be less favourable for these issuers, while there will also be additional administrative costs.

However, overall, it seems fair to conclude that the successful launch of NIBC’s CPTCB will result in more new issuers coming to the Dutch covered bond market. This is particularly true for Achmea Hypothekenbank, and to a slightly lesser extent to SNS Bank and Van Lanschot.

Fig. 3 – Mortgage share of financial institutions

![Mortgage share of financial institutions](image)

Source: Financial reports, investor presentations, ABN AMRO

Rabobank set to enter regular covered bond market
Looking at the future landscape of the Dutch covered bond market, it also seems fair to question whether new issuers will enter the regular covered bond market. Indeed, we think that Rabobank is set to launch a covered bond programme going forward. Currently, this market is dominated by ING and ABN AMRO, which have more than EUR 50 bn of outstanding covered bonds. Of the big three Dutch banks, Rabobank is the only bank that does not use covered bonds as a source of funding. One of the reasons is probably that it has always been able to fund itself relatively cheaply with unsecured

\(^1\) Only banks are allowed to issue covered bonds.
funding and RMBS notes, benefitting from its strong credit rating.

Weak economy taking its toll on balance sheet
However, Rabobank has also seen its rating being downgraded, while the weak Dutch economy is taking its toll on the quality of its balance sheet as well. Indeed, spread differentials between senior unsecured paper of other Dutch banks have generally diminished. As a result, using covered bonds as relatively cheap funding tool has become increasingly attractive for Rabobank, especially given that a covered bond programme is likely to get a firm AAA rating (given its strong issuer rating). Another advantage is that it will increase its funding diversification.

Low encumbrance provides room for large programme
The fact that Rabobank is the dominant player on the Dutch mortgage market (with a share of almost 1/3), provides it with plenty of room to start a covered bond programme. At the end of June, Rabobank had just more than EUR 210 bn of Dutch residential mortgages on its balance sheet, of which around EUR 80 bn were used in RMBS programmes. In theory, this implies that EUR 130 bn of mortgages will be available for a covered bond programme. This does not take the issue of asset encumbrance into account. However, looking at Rabobank’s balance sheet, asset encumbrance would not be an impediment for setting up a covered bond programme, as at the end of June, only 4.7% of Rabobank’s funded assets were secured funding, compared to an average of 14% of the Dutch banking sector, and 25% of the European banking sector. In theory, this implies that EUR 70 bn would be available for a covered bond programme to bring it into line with the Dutch average.

Bail-in discussion raises attractiveness of covered bonds
Another argument in favour of starting a covered bond programme is the bail-in discussion. Now that it is becoming increasingly clear that senior unsecured debt will be subject to bail-in in case of an issuer default, it is likely that ratings of this kind of debt will be lowered. In contrast, covered bonds will keep the credit enhancement stemming from their non-bail-in status, which will result in a widening in the rating of covered bonds and that of senior unsecured debt. This in turn will increase the attractiveness of covered bonds as relatively cheap funding instrument.

We estimate price of a 5Y covered bond around ms +5/10 bps and that of a 10Y at around ms +30 bps
In order to get a feeling of the extent to which Rabobank can benefit from lower funding costs by issuing covered bonds, we have made an estimate of the price of a potential 5Y and a 10Y covered bond, which we have compared with the price of recently issued RMBS notes as well as senior unsecured paper. To start with the advantage of covered bonds versus RMBS notes, we look at the EUR 550 mn of RMBS notes that Rabobank sold on 12 September. The notes had a maturity of around 5 years and were priced at 3 months Euribor +90 bps, which at the time of writing is roughly equal to mid swap + mid 80s bps. If we take the outstanding covered bonds of ING and ABN AMRO that mature in 2018 and which currently trade at ms + 6 to11 bps as proxy, it seems that Rabobank would be able to sell a 5Y euro benchmark covered bond at around ms + 5 to 10 bps, given its strong issuer rating. This implies a cost advantage of roughly 70 to 75 bps compared to RMBS notes (all else equal). Admittedly, the overall benefit is likely to be lower, as we have not taken into account the cost of additional over-collateralisation that is needed in a covered bond programme. But overall, this example illustrates that issuing a covered bond would lower Rabobank’s funding costs.

![Fig. 4 – Price of a 10Y Rabobank covered bond](image-url)

Source: Bloomberg, ABN AMRO

We can draw the same conclusion when we look at Rabobank’s recently issued EUR1.5 bn senior unsecured bond with a maturity of 10 years. The issue price of this bond was set at ms +85 bps, while it currently trades at ms + mid-60 bps according to Bloomberg data. Both ING and ABN AMRO issued a 10Y covered earlier this year, which now trade at roughly ms + low 30s. Given that Rabobank has a 2 to 3 notches higher credit rating than ING and ABN AMRO, it seems fair to assume that it could set the price of a new 10Y
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Covered bond in a range of ms +20-30 bps, more than half the price of its senior unsecured bond.

So overall, we expect Rabobank to start issuing covered bonds going forward. It will not only diversify its funding mix, but it will also be a relatively cheap funding instrument with a stable rating, which is exempted from the bail-in clause, something that investors will appreciate given still weak economic conditions in the Netherlands.

Conclusion
Overall we expect that the landscape of the Dutch covered bond market will change going forward. The successful launch of the conditional pass-through structure of NIBC will in our view attract new issuers to this part of the covered bond market, with Achmea Hypotheekbank being the most likely candidate, followed by SNS Bank as well as Van Lanschot. Meanwhile, we think that it will be beneficial for Rabobank to launch a regular covered bond programme, as it would lower its funding costs and increase its funding diversification.