**Dutch Association of Covered Bond issuers – DACB**

To Investors and other market participants interested in Dutch covered bonds

From The Dutch Association of Covered Bond issuers (DACB)

Date 11 maart 2015

Subject Dutch covered bonds: EBA compliant

1. **Introduction**

In July 2014 the European Banking Authority (EBA) issued the following report: EBA Report on EU Covered Bonds Frameworks and Capital Treatment[[1]](#footnote-1).

The timing of the issuance of this report coincided with a project of the Dutch Association of Covered Bonds issuers (DACB), the Ministry of Finance and the central bank to update the legislative and regulatory environment for Dutch covered bonds
The timing of the EBA report – which was drafted at the request of the ESRB –allowed the participants in this project to implement the EBA recommendations in the new law.

In chapter 10.1 of its report (pages 143-148) EBA refers to eight best practices which issuers have to take into account to further strengthen the covered bond frameworks in Europe.
In this paper we explain how these EBA best practices have been taken into account in the new Dutch covered bond law (effective as of January 1, 2015).

1. **EBA best practices and Dutch issuer compliance**

In this section we discuss the eight best practices as identified by EBA. We will explain why the DACB IS of the opinion that Dutch issuers are in compliance with these best practices. In most cases this will be done by simply referring to specific Articles in the Dutch covered bond law. In some instances (parts of) certain EBA best practises are not for the full 100% applicable to the Netherlands. In that case we will explain why we hold that view and what alternative solutions are in place in the Netherlands.

In the following pages we often refer to specific sections of the Dutch legislation that are related to the specific EBA best practice.

The Dutch legislative environment with respect to covered bonds consists of three different levels of law:

1. The Financial Supervision Act (FSA) - Wet op financieel toezicht (Wft)
2. The Decree on Prudential Rules under the FSA - Besluit prudentiële regels Wft (Bpr)
3. The FSA Implementing Rules - Uitvoeringsregeling Wft (Ur)

Dutch and English (unofficial translation) versions of the Wft, Bpr and the Ur can be found on the website of the DACB ([www.dacb.nl](http://www.dacb.nl) - research page).

**EBA best practices**

|  |
| --- |
| ***Dual recourse******Best practice 1: Dual recourse***  |
| *In accordance with Article 52(4) of the UCITS Directive the (covered) bond must grant the investor:* 1. *a claim on the covered bond issuer limited to the complete fulfilment of the payment obligations attached to the covered bond, and*
2. *in case of issuer’s default, a priority claim on the assets included in the cover pool limited to the complete fulfilment of the payment obligations attached to the covered bond.*

*Should the assets included in the cover pool prove insufficient to fully meet the payment obligations towards the covered bond investor, the covered bond investor should be granted a claim on the covered bond issuer’s insolvency estate which ranks pari passu with the claim of the issuer’s unsecured creditors.*  |

**Opinion DACB: fully compliant**

We refer to Article 3.33a(1a) of the Wft and Article 20b(2) of the Ur, both articles deal with the priority claim on the cover pool assets.

The recourse to the cover pool and Issuer – the claim on the latter ranks pari passu with the claim of unsecured investors – is embedded in the Dutch (segregated) covered bond structure. The Dutch covered bond is issued as a senior unsecured bond of the issuer with a guarantee from a Dutch special purpose vehicle (CBC- Covered Bond Company). The cover assets are transferred to the CBC as of inception. If the issuer fails, the CBC – under its guarantee – will make the payments (interest and redemptions) to the investors from the proceeds of the cover assets. In case the proceeds from the cover assets are insufficient, the investor can claim the difference via the Security Trustee from the insolvent estate.

|  |
| --- |
| ***Segregation of cover assets and bankruptcy remoteness of covered bonds;******Best practice 2 - A: Segregation of cover assets***  |
| *The identification and effective segregation of all the assets over which the investor has a priority claim should be ensured, depending on the issuer model adopted at the national level, either by the registration of the cover assets into a cover register and / or by the transfer of the cover assets to a special entity (SPV or specialised institution). The covered bond legal/regulatory framework should ensure that the establishment of the cover register and/or the transfer of the (cover) assets to a special entity result in legally binding and enforceable arrangements, including in the event of default or resolution of the issuer.* *The segregation arrangement should include all primary assets covering the covered bonds as well as substitution assets and derivatives entered into to hedge the risks arising in the covered bond programme and registered in the cover pool.*  |

 **Opinion DACB: fully compliant**

The EBA refers to two different models for asset segregation: 1.) registration in a cover register and 2.) transfer to a special entity. In the Netherlands it is the latter, cover assets are transferred to a bankruptcy remote entity, the Covered Bond Company (see also Best Practice 1).

The related Articles in the Dutch law are: Article 3:33a, 1 of the Wft, Article 40d(1, 2a) of the Bpr that deals with segregation of assets and Article 20a(a,b) of the Ur.



**Opinion DACB: fully compliant**

This Best Practice refers to three items: 1.) no automatic acceleration upon issuer’s default, 2.) priority claim of covered bond investors and parties that rank at least pari passu and 3.) a plan on operational procedures post issuer default.

The Dutch covered bond programs are set up in such way that the after a default of the issuer the CBC is required to make the scheduled interest and notional payments in a timely manner. Investors are therefore paid in priority from the cover pool over unsecured creditors of the issuer. No acceleration of the covered bonds takes place in that event.

With respect to the priority claim of the covered bonds investors – and parties that rank at least pari passu with these investors – we refer to our comments under Best Practice 1 (Articles 3.33a(1a) of the Law and 20b(2) of the Ur).

With respect to the operational procedures post-issuer default we refer to Article 20a(c) of the Ur. This article requires Dutch issuers to develop a plan for the management of the cover pool post issuer default.

|  |
| --- |
| ***Best practice 2 - C: Administration of the covered bond programme post issuer’s default or resolution***  |
| *The legal/regulatory covered bond framework should provide that upon issuer’s default or resolution the covered bond programme is managed in an independent way and in the preferential interest of the covered bond investor.* *The legal/regulatory covered bond framework should provide for clear and sufficiently detailed provisions over the duties and powers of the administrative function so as to ensure that the latter can take all action which may be necessary for the full realisation of the interests of the covered bonds investor, while maintaining a high level of legal clarity and transparency vis-à-vis the investor over the covered bond management in scenarios of potential distress such as the issuer’s default or resolution.*  |

 **Opinion DACB: fully compliant**

The CBC to which the assets are transferred is established as a bankruptcy remote entity. The issuing bank is not allowed to hold any shares or ownership rights in the CBC nor is it allowed to exercise a form of policy-setting control, in this way independent management form the issuer’s insolvency estate is guaranteed.

In the Dutch covered bond structure there are typically two trust companies involved: 1.) a trust company as director responsible for the management of the CBC and 2.) a trust company as director of the (security) trustee that represents the interests of the covered bond investors.

We refer to Article 40d(2b) of the Bpr and Articles 20a(d) and 20b(1) of the Ur.

|  |
| --- |
| ***Characteristics of the cover pool******Best practice 3 - A: Composition of the cover pools***  |
| *Cover pools comprising both residential mortgage (or guaranteed) loans and commercial mortgage loans should be structured and managed so as to ensure that the composition by mortgage type (residential vs. commercial) which characterises the pool at issuance does not materially change throughout the life of the covered bond, for reasons other than the amortisation profile of the cover assets.* *The EBA considers that regulatory limits on the composition of these mortgage pools could represent a best practice to ensure that a certain degree of consistency is maintained in the risk profile of the cover pool throughout the life of the covered bond. The EBA also acknowledges that other tools may equally ensure consistency and stability in the composition of mixed cover pools, including contractual arrangements on the composition of the mixed cover pools and the supervision on the composition of mixed pools based on supervisory guidelines.* *Cover pools which comprise primary asset classes other than residential or commercial mortgages (not taking into account asset classes included in the pool as substitution assets), should consist exclusively of one primary asset class.*  |

 **Opinion DACB: fully compliant**

Dutch issuers are not allowed to establish categories (programs) of covered bonds were the primary cover assets consist of more than one asset class, expect for mortgage loans. A combination of residential and commercial mortgage loans is allowed under the same category of covered bonds provided that the allocation between the two asset classes is fixed within certain boundaries (as approved by the Dutch Central Bank at inception of the category).

We refer to Article 40e(1b), (2), (3) and (4) of the Bpr.

|  |
| --- |
| ***Best practice 3 - B: Cover pools with underlying assets located in different jurisdictions*** |
| *The legal/regulatory covered bond framework should provide that cover pools are generally limited to comprise of assets located in the EEA, as this ensures that liquidation of collateral in the case of issuer default is legally enforceable.* *In the case of cover assets that are loans secured by mortgages on residential or commercial property located in a non-EEA jurisdiction, it should be assessed that the requirements provided for in Article 208(2) of the CRR are met and that the priority claim of the covered bond investor is legally enforceable in an issuer’s insolvency scenario in the jurisdiction under consideration. For cover assets other than mortgages, it should similarly be ensured that access to the cover assets is legally enforceable. Underwriting standards should be similar to the ones applied on comparable loans granted in EEA jurisdictions and the loans should have similar risk characteristics.* *In addition non-EEA jurisdictions should apply prudential supervisory and regulatory requirements at least equivalent to those applied in the Union, as per Article 107(4) of the CRR.* |
| **Opinion DACB: fully compliant**To date (January 1, 2015) Dutch issuers have only issued covered bonds with Dutch and/or German (only NIBC) residential mortgage loans as cover assets. In addition the Dutch legislation is fully compliant with CRR. We refer to Article 40e(1c), (2) of the Bpr and Article 20c of the Ur.  |

|  |  |  |
| --- | --- | --- |
|

|  |
| --- |
| ***Best practice 4 - A: LTV limits***  |
| *The legal/regulatory covered bond framework should establish maximum LTV parameters to* *determine the percentage portion of the loan that contributes to the requirement of coverage of* *the liabilities of the covered bond programme (so-called ‘soft LTV limits’).* *While the EBA sees merits in the LTV limits being not only coverage limits (soft LTV limits) but also eligibility limits (i.e. limits whose breach determines the full non-eligibility of the loan for inclusion* *in the cover pool; also referred to as ‘hard LTV limits’) when a given loan is included in the cover* *pool for the first time, the EBA is concerned about the ongoing application of eligibility LTV limits* *to loans already included in the cover pool. A severe downturn of real-estate prices, in the* *presence of ‘hard LTV limits’, may determine coverage disruptions in covered bond programmes.*  |

 |

**Opinion DACB: fully compliant**

The Dutch legislative environment forces issuers to fully comply with Article 129 of CRR ( a precondition for registration with the Dutch Central Bank). This automatically means that the percentage portion of the loan that contributes to the requirement of coverage of the liabilities meets the maximum LTV parameters of Article 129 of CRR, i.e. 80% LTV cut off for residential mortgages and 60% for commercial real estate.

We refer to Article 40e(3b) and (3c) and Article 40f(2)of the Bpr.

|  |
| --- |
| ***Best practice 4 - B: LTV measurement and frequency of re-valuation***  |
| *The legal/regulatory covered bond framework should establish that the value of the property securing a particular loan, and the corresponding regulatory LTV limit determining the contribution of that loan to the coverage requirement, be monitored and updated (e.g. at least via an indexation or other statistical method) at least on a yearly basis for both residential and commercial properties, and more frequently where either the management of the covered bond programme or the cover pool monitor or the competent authority deem appropriate.* *The framework should specify that the re-valuation of the properties securing the loans should be based on transparent valuation rules and be carried out by an agent who is independent from the credit granting process. As a minimum the valuation process should be compatible with the conditions laid down in the first and second subparagraph of Article 229(1) of the CRR.*  |

**Opinion DACB: fully compliant**

With respect to the ongoing compliance with the LTV parameters of CRR 129 (EBA mentions a possible breach resulting from a downturn in real estate prices), we refer to Article 20d(4) and (5) of the Ur.
Besides the fact that Article 20d(4) of the Ur explicitly refers to Article 129(3) of the CRR[[2]](#footnote-2), Article 20d(5) requires Dutch issuers to revalue their real estate cover pool assets at least annually when calculating the minimum required over-collateralisation ratio as described in Article 40f(2) of the Bpr.

**Coverage principle and over-collateralisation**

|  |
| --- |
| ***Best practice 5: Coverage principles and legal/regulatory over-collateralisation*** *The legal/regulatory covered bond framework should ensure that all the liabilities of the covered bond programme, including liabilities towards counterparties in derivative contracts and, as applicable, liabilities towards managers/administrators, servicers, trustees, cover pool monitors and similar entities involved in the process of the covered bond issuance, are covered by the cover assets.* *The EBA considers that a legal/regulatory minimum over-collateralisation level constitutes a regulatory best practice. The recommendation of a quantitative legal/regulatory minimum over-collateralisation level would require further analysis as it depends on several factors including, but not limited to, the class of cover assets as well as, crucially, the chosen coverage principle among the several different coverage principles currently adopted across jurisdictions (nominal, net present value, prudent market value, net-present value under stress, etc.).* |

 **Opinion DACB: fully compliant**

For the Best Practice that all liabilities of a covered bond program should be covered by cover assets (first part of Best Practice 5) we refer to Article 40g(1c)and (3) of the Bpr and 20e(2) of the Ur.
The second part of this Best Practice refers to minimum over-collateralisation levels. Dutch issuers have to comply with two minimum over-collateralisation ratios, 105% (Article 40f(1) of the Bpr) and 100% (Article 40f(2) of the Bpr). The 100% ratio requires Dutch issuers to take the LTV parameters of Article 129 of the CRR into account when calculating the denominator.

**Assets and liabilities risks**

|  |
| --- |
| ***Best practice 6 - A: Use of derivatives***  |
| *The legal/regulatory covered bond framework should specify that derivative instruments are allowed in covered bond programmes exclusively for risk hedging purposes.* *The legal/regulatory covered bond framework should provide that derivative contracts entered into by the covered bond issuer with a derivative counterparty, and registered in the cover pool, cannot be terminated upon issuer insolvency.*  |

**Opinion DACB: fully compliant**

Article 20b(3) of the Ur covers that derivatives are only allowed for risk hedging purposes and the contracts cannot be terminated after a default of the issuer.

|  |
| --- |
| ***Best practice 6 - B: Liquidity buffer***  |
| *The EBA considers that a requirement to mitigate liquidity risk in the covered bond programme, by means of liquid assets available at all times to cover the cumulative net out-flows of the covered bond programme over a certain time frame, constitutes a regulatory best practice. Determining the calibration and scope of a best practice requirement would require further analysis since, as the report acknowledges, different structures of the covered bond programme - e.g. hard bullet, soft bullet and conditional pass-through structures - expose to different extents the covered bond programme to liquidity risk.*  |

**Opinion DACB: fully compliant**

The liquidity buffer requirement for Dutch issuers applies to redemptions and interest rate payments that are due within six months. However, if Dutch issuers have the possibility to postpone their redemption with at least six months, there is no liquidity buffer requirement for the redemption amount.

We refer to Article 40g of the Bpr and 20e of the Ur.

|  |
| --- |
| ***Best practice 6 – C: Stress testing*** |
| *The legal/regulatory covered bond framework should require covered bonds issuers to carry out stress test exercises on the calculation of the coverage requirement taking into account, at least, the following factors:* * *Shifts of relevant interest rate curves based on historical performance, where data is available;*
* *Shifts of the currency pairs relevant to the covered bond programme based on historical performance, where data is available;*
* *Stresses on the credit quality of the underlying assets based on historical performance, where data is available;*
* *Stresses on the re-payment behaviour of the underlying assets based on historical performance, where data is available;*
* *Stresses on the liquidation price of the underlying assets based on historical performance, where data is available*

*The stress test should also take into account other risks, including but not limited to, set-off risks and commingling risks.*  |
|  |
| **Opinion DACB: fully compliant**The stress test for Dutch issuers is currently (January 1, 2015) being developed in close cooperation with the Dutch Central Bank. In their stress test Dutch issuers have to take the following factors into account:* Credit risk
* Currency and interest rate risk
* Liquidity risk
* Any other risks deemed relevant by the Dutch Central Bank

The main aim of the stress test is to ensure that Dutch issuers maintain a healthy balance sheet ratio with respect to the assets used as cover pool assets and the freely available eligible assets on their balance sheet (i.e. the assets that have not been transferred to the Covered Bond Company as cover pool assets). This healthy ratio is determined on an issuer-by-issuer basis by the Dutch Central Bank. We refer to Article 40i of the Bpr and Article 20g of the Ur.The commingling risk has been addressed by Dutch issuers either by way of contractual agreement (transaction documentation) or by creating a collection foundation that collects all payments. In their programs the Issuers take set off risks also into account by effectively increasing the cover pool. Deposit set off risk is mitigated by deducting amounts, that are deposited by the borrowers with the issuer, in the asset cover test. Insurance set off risk is mitigated by a decrease of the asset percentage and/or by a deduction through the asset cover test. **Role of the competent authority and monitoring of the cover pool**

|  |
| --- |
| **Best practice 7 - A: Appointment of the Cover Pool Monitor**  |
| The legal/regulatory covered bond framework should provide that, at establishment of a given covered bond programme, a cover pool monitor is appointed. The framework should: i) ensure that the cover pool monitor is an internal or external entity other than the ordinary auditor of the covered bonds issuer; ii) provide for the eligibility criteria for the appointment and the cover pool monitor’s main duties and powers including, but not limited to, the monitoring of all coverage requirements and eligibility tests and the random auditing of the cover pool. Where similar tasks are directly carried out by the competent authority the appointment of a cover pool monitor may not be necessary. The cover pool monitor and/or the issuer, based on the findings of the cover pool monitor, should regularly report to the competent authority.  |

 |

**Opinion DACB: fully compliant**

In the Netherlands an external accountant is appointed which has the following responsibilities:

1. Check calculations related to liquidity buffer (at least annually)
2. Check calculations related to over-collateralisation ratios (at least annually)
3. Check files of cover pool assets on a random basis (at least annually)

We refer to Article 20f of the Ur.

|  |  |  |
| --- | --- | --- |
|

|  |
| --- |
| ***Best practice 7 - B: Supervision of covered bond issuer*** |
| *The legal/regulatory covered bond framework should provide that the competent authority approves the establishment, by a given issuer, of a covered bond programme. A covered bond programme shall be considered to have been established when a cover pool is established for the inaugural covered bond issue. Within the same covered bond programme additional collateral may be subsequently added to the cover pool and further covered bonds may be issued granting investors claims which rank pari passu with the claims attached to the existing bonds collateralised by the same cover pool, in the event of issuer’s insolvency.* *At the establishment stage the competent authority should be satisfied, at least on the basis of information received from the issuer, that: i) adequate operational policies, procedures and controls are put in place by the issuer for the management of the covered bond programme, including in the event of issuer insolvency or resolution; ii) where provided by the national framework, the restrictions applicable to the issuer are met; iii) the features of the cover pool meet the applicable requirements.* *The EBA acknowledges that the supervisory practice of licensing specialised covered bond issuers, which only carry out the covered bonds issuance activity and related ancillary activities, may ensure a level of supervision of the issuer which is comparable to the one achieved by the authorisation of the establishment of a new covered bond programmes. In any case all the applicable requirements attached to the granting of the licence should be regularly monitored and the establishment of new covered bond programmes should as a minimum be subject to ex-ante notification to the national authority.* *The legal/regulatory covered bond framework should provide a clear and sufficiently detailed illustration of the duties and powers of the competent authority regarding the ongoing supervision of the applicable activities/regulatory requirements of covered bond issuers.*  |

 |

**Opinion DACB: fully compliant**

In the Dutch legislative environment many references are made to the roles and responsibilities of the Dutch Central Bank. These roles and responsibilities can be related to (non-exhaustive list):

1. Adequate segregation of assets
2. Priority claim of covered bond investors
3. Compliance with the requirements of Article 129
4. Maintenance of a healthy ratio between cover pool assets transferred to CBC and freely available eligible assets on balance sheet of issuer
5. Approval of issuer’s plan for adequate management of the cover pool post issuer default
6. Stress test performed by the issuer
7. Does the issuer meet the minimum requirements for the liquidity buffer and over-collateralisation ratios

We refer to Article 3.33(a) en (b) of the law, Articles 40d,e, h and 40i of the Bpr and Articles 20a, 20d(5), 20g and 20h of the Ur.

|  |
| --- |
| ***Best practice 7 - C: Duties and powers of the national authority in the event of issuer insolvency***  |
| *The legal/regulatory covered bond framework should provide a sufficiently detailed description of the duties and powers of the competent authority on the covered bond programme, as well as its administration, in the event of issuer’s default.*  |

**Opinion DACB: fully compliant**

The situation post issuer default is described in a plan that the Dutch issuers have to submit to the Dutch Central Bank before they are allowed to issue covered bonds.
Besides this the Dutch Central Bank will never cancel the registration of any outstanding covered bonds. So whilst issuers can be de-registered, covered bonds cannot. This ensures continued oversight of the covered bonds by the Dutch Central Bank in a post default situation of the issuer (as long as they receive all the relevant information from the Trustee).

We also refer to Article 3:33a of the Wet and 20a(c) of the Ur.

**Disclosure to investors**

|  |
| --- |
| ***Best practice 8 – A: Scope of disclosure***  |
| *The legal/regulatory covered bond framework should require covered bonds issuers to disclose aggregate data on the credit risk, market risk and liquidity risk characteristics of the cover assets and the covered bonds of a given programme as well as other relevant information, including information concerning the counterparties involved in the programme and the levels of contractual and voluntary over-collateralisation. The information should be disclosed to a level of detail which enables investors to carry out a comprehensive risk analysis.*  |

 **Opinion DACB: fully compliant**

As part of the ECBC Label Convention Dutch issuers have developed a National Transparency Template (NTT). This NTT is compliant with Article 129(7) of the CRR (it actually contains considerable more information than required by this article).
The Dutch National Transparency Template is currently (January 1, 2015) being updated to comply with both the latest ECBC recommendations (Covered Bond Label) and the new legislative environment in the Netherlands. The investor reports can be downloaded via the DACB website ([www.dacb.nl](http://www.dacb.nl), investor reports page).

We refer to Article 3.33b(2) of the law, Article 40j(b) of the Bpr and Article 20i of the Ur.

|  |
| --- |
| ***Best practice 8 - B: Frequency of disclosure***  |
| *The legal/regulatory covered bond framework should provide that the disclosure of the information mentioned under recommendation 8 –A should occur at least on a quarterly basis.*  |

 **Opinion DACB: fully compliant**

Dutch issuers publish their investor reports on a monthly basis.

1. **Conclusion**

The EBA report on EU Covered Bonds Frameworks and Capital Treatment was published at the same time when the DACB was involved in discussions with the Dutch central bank and the Ministry of Finance to update and improve the Dutch covered bond law. This allowed the participants in the project to update the Dutch legislative and regulatory environment while taking the EBA recommendations (best practices) into account.

Dutch covered bonds have a strong legal and supervisory framework. The framework covers all areas identified by the EBA: the dual recourse mechanism, asset segregation and bankruptcy remoteness, cover pool features, valuation and LTV limits, risk management and stress testing, monitoring and the role of the regulator. At the same time Dutch issuers provide full transparency towards covered bond investors by releasing detailed investor reports on a monthly basis.

The DACB is of the opinion that – once Dutch issuers have implemented all the changes –they are complying with the best practices as identified by EBA. It goes without saying investors cannot rely on the view of the DACB. Investors should prepare their own analysis – or seek advice from independent third parties – to see whether or not they agree with the DACB statement that Dutch issuers are complying with all EBA recommendations.

1. **EBA REPORT ON EU COVERED BOND FRAMEWORKS AND CAPITAL TREATMENT**

Response to the Commission’s call for advice of December 2013 related to Article 503 of the Regulation (EU) No 575/2013 and to the ESRB Recommendation E on the funding of credit institutions of December 2012 (ESRB/12/2). [↑](#footnote-ref-1)
2. Article 129(3) of the CRR refers to Articles 208 and 229(1) of the CRR [↑](#footnote-ref-2)