Information sheet

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Outline of the 2015 Dutch covered bond regulations

Disclaimer
This information sheet has been issued by the Dutch Ministry of Finance to give investors and other interested parties an impression of the content of the amended Dutch covered bond regulations. The exact meaning of the Dutch covered bond regulations is determined by the legislative texts published in the official journals of the Dutch State. All parties are advised to consult the official texts. This paper cannot be used to interpret these official texts. The Dutch State is not liable for any omission or misrepresentation of the content of the regulations in this information sheet.

Introduction

In 2008 the Netherlands introduced a legal framework for regulated covered bonds ("the 2008 regulations"). This enabled banks domiciled in the Netherlands to issue regulated covered bonds that comply with the conditions for preferential treatment under article 52.4 UCITS Directive.

In 2012, the Ministry of Finance has started a consultation of market parties, such as investment banks, commercial banks, national and foreign investors and rating agencies, to find out whether there was scope for improvements of the regulations. The outcome was that, while the 2008 regulations have enabled the development of a well-functioning market for Dutch regulated covered bonds, it was widely regarded that setting more detailed quality standards for regulated covered bonds would be beneficial.

Thus, the Ministry of Finance has decided to undertake a full revision of the Dutch covered bond framework. This was undertaken in close cooperation with the responsible supervisor, the Dutch Central Bank (DNB) and in consultation with issuing banks and specialized lawyers. This has resulted in a new framework that is scheduled to enter into force as of 1 January 2015 ("the 2015 regulations").

The 2015 regulations aim to provide more safeguards to covered bond holders, while respecting other interests that are connected with the issuance of covered bonds, such as avoiding on undesirable degree of asset encumbrance. The 2008 regulations consist of a limited, principle based framework that gave issuing banks a large amount of flexibility. While a considerable amount of flexibility is retained, the new framework contains more detailed proscriptions to increase transparency and protection for investors. The result is a framework

that sets out detailed requirements where possible and uses principle based rules where desirable, while still retaining a fair amount of flexibility for issuing banks according to their needs and investors' wishes.

Under the new framework, Dutch regulated covered bonds will have to comply with the conditions for preferential treatment of article 52.4 UCITS, article 129 CRR and the best practices indentified by EBA in the *EBA report on EU covered bond frameworks and capital treatment* published on 1 July 2014 ("EBA best practices").

Amendments

Whereas the 2008 regulations were part of a government and ministerial decree, the new regulations will also include rules on the level of parliamentary law. The rules in the government and ministerial decree will undergo a full revision. The substance of the main changes to the covered bond framework will be outlined below.

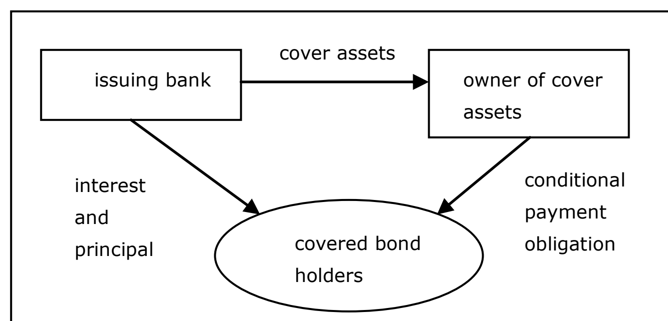
A. Legal basis and sanctions

The foundations for the covered bond regulations will be laid down in parliamentary law, by an alteration of the Financial Supervision Act ("Wet op het financieel toezicht"). This includes the definition of covered bonds, based on the UCITS directive, the registration of covered bond programs by the supervisor and a delegation to lay down additional rules by government or ministerial decree.

The inclusion of rules on parliamentary law level enable a more extensive and proportional sanctions regime. Under the 2008 regulations, the supervisor can eliminate the registration of a covered bond if the issuing bank does not meet the requirements. The supervisor has no other sanctioning powers. Under the new regime, other sanctions, such as fines, are made possible. Additionally, the supervisor can eliminate the registration of the issuing bank, after which the issuing bank will not be allowed to issue more covered bonds. The registration of a covered bond program cannot be cancelled anymore.

B. Enhanced structural safeguards

The structure used to separate the cover assets from the issuing bank will remain the same. Segregation of the cover assets will take place by transfer ("overgang") of the cover assets to a separate legal entity (also called the Covered Bond Company or "CBC"). This owner of the cover assets will have an obligation to pay interest and principal to the bond holders, if the issuing bank fails to do so. The structure can be pictured schematically as follows:



The owner of the cover assets will have to be insolvency remote in relation to the issuing bank. To ensure this, the 2008 regulations as well as the 2015 regulations prescribe that the issuing bank cannot own or control the owner of the cover assets.

Additional safeguards have been included to ensure that the recourse of the bond holders is not limited by other transactions entered into by the owner of the cover assets. The owner of the cover assets can only enter into transactions that result in obligations that are equally or higher ranked compared to the obligations to the bond holders, if these are entered into in the interest of the management, risk management, or administration of the covered bonds or to facilitate payment to the bond holders.

A new rule is included that the conditions of a covered bond program may not include provisions that would be an obstacle to supervision on the covered bonds. The rule is formulated in a principle based manner. The issuing bank is free to structure the covered bond as it deems fit - subject to the conditions of the legal framework. The rule serves to avoid that the issuing bank uses this flexibility in an irresponsible way.

C. <u>Asset quantity</u>

To avoid immediate payment issues of the owner of the cover assets in the event of a default of the issuing bank, a liquidity buffer has to be held that covers interest payments, principal payments and senior costs that will be due in the coming six months. In case of structures with an extension period of at least six months, no liquidity needs to be held for principal payments.

The requirement may be met by cash flows generated by the cover assets in the upcoming six months. If this is not enough to create an adequate coverage level, the owner of the cover assets will have to hold liquid assets. Liquid assets are public sector loans and exposures to institutions as defined in article 129.1 CRR. Cash flows from derivatives and other risk management instruments will be taken into account when calculating the liquidity needed and available.

A central rule that protects investors is the minimum level of overcollateralization of 5% that will be introduced. This means that the nominal value of the cover assets must be 105% of the nominal value of the outstanding covered bonds under the relevant program.

An additional collateralization requirement, which is calculated separately, is that the nominal size of the cover assets taking into account the cut-off rules for collateralized assets of article 129.1 CRR that relate to the value of the pledged property as well as prior pledges, is at least equal to the nominal value of the outstanding covered bonds.

D. <u>Asset quality</u>

Under the 2008 regulations, no restrictions applied as to the nature of the assets in the cover pool. In practice, the cover pools of Dutch issuing banks consist of residential real estate loan only. The 2015 regulations restrict primary cover assets to those assets than can be used to an unlimited extent under article 129 CRR: public sector loans, residential real estate loans, commercial real estate loans, and shipping loans. In addition, up to 20% of the outstanding bonds under a

program can be covered by substitution assets. These are the liquid assets that are allowed (partly only to limited extent) under CRR: public sector exposures and exposures to institutions. RMBS and CMBS are excluded as cover assets because of transparency and simplicity considerations.

The allowed geographical scope of the cover assets remains roughly the same: assets from EEA jurisdictions and countries that have been accepted as jurisdictions that apply equal regulatory and supervisory requirements.

The 2015 framework will include rules on valuation of cover assets. As a main rule, cover assets will be valued at their nominal value. Substitution assets will have to be valued at market value according to an internationally accepted accountancy standard. Several categories of assets will be awarded no value when applying the overcollateralization requirements (see under C). This applies to:
1. impaired loans, as defined by article 178 CRR
2. assets to which a specific legal claim is attached that takes preference of the ownership entitlement of the owner of the cover assets, up to the value of that specific legal claim
3. assets that consist in an exposure of the owner of the cover assets to the issuing bank or one of the entities of the same group

Issuing banks will be required to appoint an asset monitor, being an external accountant that will have to perform a yearly audit of certain aspects of the administration and valuation process. More specifically, the external accountant has to:
1. perform a check on the calculation of the coverage of the overcollateralization requirement;
2. perform a check on the calculation of the liquidity buffer requirement;
3. perform a check on a yearly sample of the files related to the cover assets.

Article 208 CRR regarding the requirements for collateral consisting of real estate and article 229.1 CRR have to be applied in the valuation process. Cover assets consisting of (residential or commercial) real estate loans will have to be valued on a yearly basis. In line with article 208 CRR, this can be done using statistical methods. The supervisor may require more frequent valuation if it sees a reason to do so, for examples in times of market stress.

E. Transparency

In order to increase transparency of the programs, issuing banks are required to record certain essential characteristics at the registration of a program. These cannot be changed anymore afterwards. These essential characteristics are:
1. cover asset class
2. extension period
3. jurisdiction of cover assets

For the characteristics under 1 and 2, the 2015 regulations give a limited number of options for the issuing banks to choose from. For asset classes, the issuing bank will have to choose between:
1. public sector loans
2. residential real estate loans

3. commercial real estate loans
4. shipping loans
5. a combination of 2 and 3 in a fixed ratio, to be chosen by the bank

For the extension period, there will be two options: firstly, the issuing bank can choose to issue covered bonds with no extension period or an extension of up to 24 months or, secondly, it can register a program with bonds with an extension period of more than 24 months. As to the jurisdiction of the cover assets, issuing banks are allowed to choose any combination of jurisdictions at registration, as long as these are accepted within the regulatory framework (see under D).

Another element of transparency is mandatory investor reporting, which enables bond holders to monitor their investment. The information that issuing banks will be required to report is based on article 129.7 CRR and the EBA best practices.

F. Post default safeguards

The 2008 regulations do not provide much detail as to the exercise of supervision once an issuing bank has defaulted. To remedy this, several new rules have been included.

The manager of the owner of the cover assets will have to be a licensed trust office that is under supervision of the Dutch Central Bank on the basis of the Dutch law on supervision of trust offices ("Wet toezicht trustkantoren"). Alternatively, the manager can be an entity under foreign law who has to comply with equal regulatory and supervisory standards. The supervision on the manager of the owner of the cover assets therefore encompasses integrity of the personnel, soundness of the financial administration and internal controls.

In line with EBA best practices, the issuing bank will be required to submit to the supervisor a plan for management of the cover assets in the event of issuing bank default. The plan will, amongst others, contain a description of the activities that are undertaken for the risk management, payment and administration of the cover assets and what activities will have to be transferred to the owner of the cover assets upon issuing bank default. The plan will have to consider the operational side of the transfer of activities, including IT and personnel related aspects.

After issuing bank default, the supervisor will continue to monitor whether the covered bonds comply with article 129 CRR and will show this in its covered bond register. In order to assess this, the owner of the cover assets will have to provide the necessary data to the supervisor. As long as the data are provided, and the requirements are met, the registration is maintained.

Lastly, the 2015 regulations contain specific safeguards relating to derivatives and other instruments for risk management (such as credit lines) and issuing bank default. The relevant derivatives and other contracts may not contain clauses that give the counter party the right to cancel the contract upon issuing bank default or issuing bank loss of creditworthiness.

G. Healthy ratio requirement reinforced by stress testing

Similar to the 2008 regulations, the 2015 regulations will require issuing banks to maintain a "healthy ratio" between the outstanding covered bonds and the balance sheet of the issuing bank. The healthy ratio requirement ensures that the interests of other (unsecured) creditors of the bank are respected. The supervisor has the power to prohibit banks from covered bond issuance that conflicts with the healthy ratio requirement.

The maximum level of covered bond issuance according to this requirement is set by the supervisor based on a discretionary assessment of both the characteristics of the covered bonds (e.g. total nominal value, level of overcollateralization) and the characteristics of the balance sheet of the bank (e.g. asset encumbrance). In contrast with some other countries, the Netherlands did not choose to set a fixed limit for all banks, as this could result in a limit that is either too high or too low in individual cases. The healthy ratio requirement also implies that the issuing bank is obliged to keep enough unencumbered assets that are eligible as cover assets available on its balance sheet.

As a new element, the issuing bank will be required to perform yearly stress tests to assess whether the healthy ratio will be maintained in adverse scenarios. Risks to be taken into account include credit risk, interest rate risk, currency risk and liquidity risk.

H. Removal rating requirement

Under the 2008 regulations, a cover bond program has to obtain a minimum rating of AA- (Fitch or S&P) or Aa3 (Moody's). If this rating is not obtained, or a program is downgraded below this level, an issuing bank is not allowed to issue covered bonds under the relevant program.

The rating requirement will be deleted in the 2015 regulations. This will contribute to issuing banks stability in times of stress, because they will have more access to the covered bond market after a rating downgrade. It will also reduce the rating dependency of the regulations.

Entry into force

The 2015 regulations are scheduled to enter into force as of 1 January 2015. Existing programs and programs for the registration of which an application has been filed before 1 January 2015, will have to comply with the new rules by 1 January 2016.