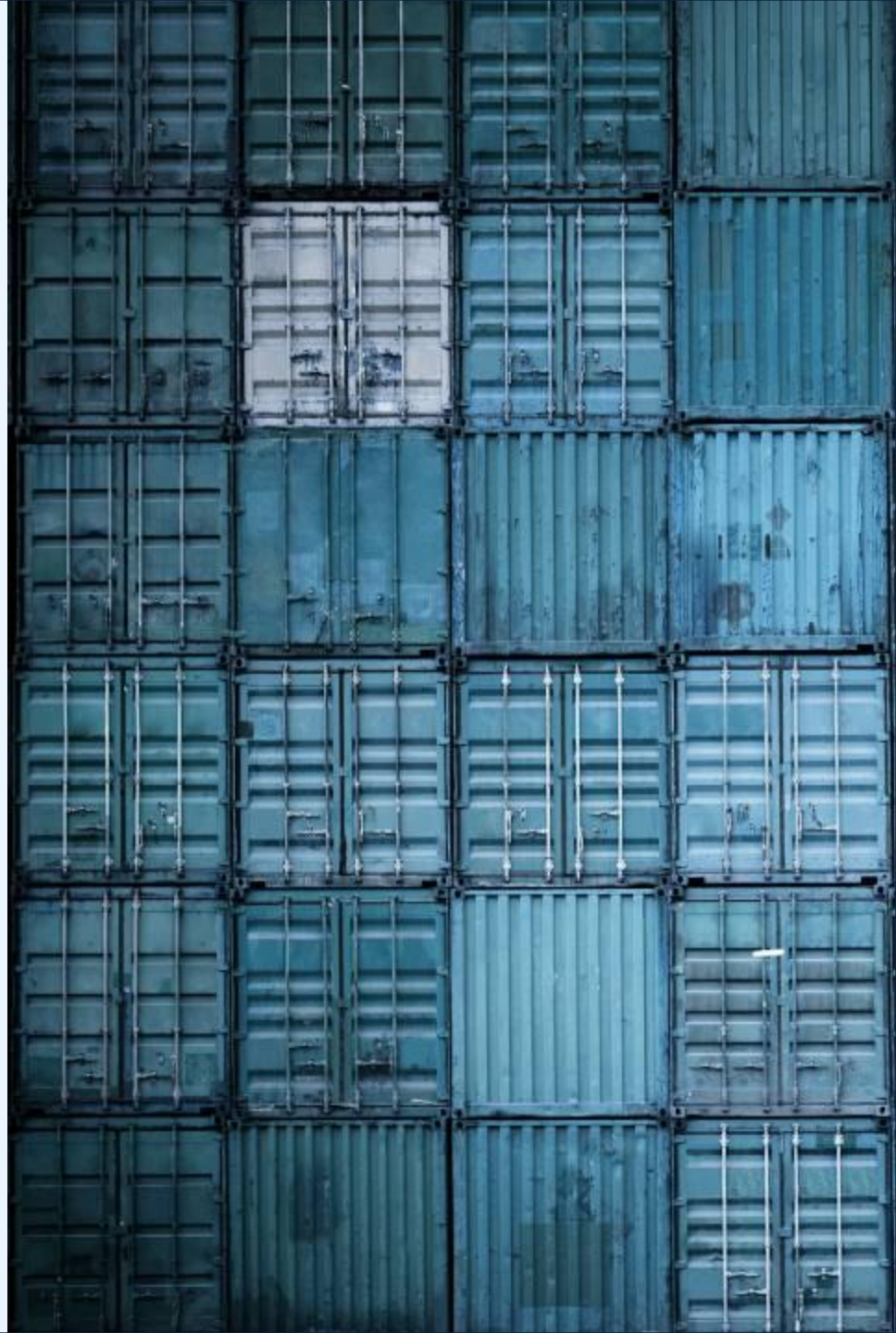


A legal framework for the use of derivatives in cover pools

18 November 2011

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I. Introduction

1. Why regulating the use of derivatives in cover pools?

- Classical covered bonds are based on “tangible“, simple assets (mortgage loans, municipal loans, etc.).
- Derivatives seen as complex financial products.
- Derivatives can be used to circumvent applicable investment limitations for cover pools.

2. Why is there a need for derivatives in cover pools?

- Principally, for hedging purposes:
 - Currency mismatches between assets and covered bonds, mainly resulting from increasing international diversification of assets.
 - Interest rate mismatches.
 - Locking in interest rates in anticipation of bond issuances.
 - Credit risk mitigation?



I. Introduction

- But potentially also for investment purposes:
 - Notional exposure where a direct exposure cannot be obtained?
 - Monetising assets before their contractual maturity?
 - Cover pools as “trading books“?



II. Qualifying derivative instruments

1. Types of derivatives

- Is it sensible to limit the types of instruments?
 - Swaps and variations (roller-coaster, callables/puttables, yield curve, spread-lock etc.)
 - Options and variations (average rate/strike, barrier, binary, ladder, etc.)
 - Futures/forwards
 - Combinations (swaptions, collars, floors)
 - CFDs
 - CDSs
- Guiding principle: risk, not form should be determining.

II. Qualifying derivative instruments

2. Purpose of derivatives

- Is it sensible to distinguish between “hedging” and “speculative” derivatives?
 - Intent vs. objective need? How can the counterparty be made comfortable?
 - When shall this be determined? When the agreement is made, later?
 - E.g. Sec. 2 (5) and 3 (1) Austrian Pfandbrief Act: Only interest rate, currency and credit risk hedging instruments. Registration as irrebuttable presumption for hedging purpose
 - E.g. Sec. 3 (6) and Sec. 14 (5) Hungarian Act on Mortgage Banks and Mortgage Bonds: Only “for hedging purposes by reason of liquidity and risk management“. Mandatory currency hedging. Similar requirement in Poland and Luxembourg.
- Again: risk, not subjective purpose should matter.

II. Qualifying derivative instruments

3. Eligible underlyings and risks

- Derivatives in cover pools should be limited to exposures which the cover pool could also invest in directly. No circumvention of investment limits.
 - How to define “direct“ investment, e.g. lack of underlying with same maturity/currency/yield?
 - Liquid vs. illiquid underlyings – may derivatives change the profile?
 - Tax optimisation?
- Excluding improper risk:
 - Not acting as seller of options.
 - Not creating (synthetic) short positions.
 - Not (mis-)using derivatives to convert cover pool into a “trading book“.

II. Qualifying derivative instruments

- Borderline issues:
 - Credit derivatives – acting as protection buyer if quantitative limits / credit standards are exceeded?
 - Credit derivatives – acting as protection seller to acquire synthetic exposure to qualifying underlyings?
 - Freight rate derivatives as hedge for ship mortgages?

4. Documentation requirements

- Derivatives in cover pools should only be documented through standardised and internationally accepted documentation, e.g.
 - ISDA Master Agreement – Multicurrency – Cross Border
 - German Rahmenvertrag für Finanztermingeschäfte
- Standard master agreements now amended by special schedules/annexes for dealings with German Pfandbrief issuers

II. Qualifying derivative instruments

5. Qualifying counterparties

- Should counterparties be limited?
 - Licensed credit institutions and investment firms (EEA; Non-EEA)
 - Licensed investment companies (UCITS; Other)
 - Licensed insurance/reinsurance companies (EEA; Non-EEA)
 - Central counterparties (as defined in EMIR)
 - Central and local governments (EEA; Non-EEA)
- Should counterparty limitations be lifted if CCP clearing becomes mandatory?
 - Unclear whether all covered bond issuers will qualify as “financial counterparties” (Article 2 (6) EMIR).
 - If covered bond issuers qualify as “non-financial counterparties” (Article 2 (7) EMIR), CCP clearing obligation only applies if certain thresholds are exceeded.
 - Privilege for intra-group transaction (Article 3 (1) (a) EMIR).

II. Qualifying derivative instruments

6. Quantitative limits

- Is it sensible to limit the exposure of cover pools to derivatives?
 - Germany originally limited NPV of claims from derivatives to 12% of total assets of the cover pool. Liabilities from derivatives are limited to 12% of total outstanding amount of covered bonds + NPV of liabilities from derivatives.
 - Since 2009 “pure currency hedging derivatives“ are excluded from this limitation.
 - Purpose of limitation: avoiding volatility in (mandatory) over-collateralisation of cover pool.
 - Hidden purpose: Limiting “erosion“ of cover pool by derivatives?
- In practice, these limits are not tested.

II. Qualifying derivative instruments

Pfandbriefe in issue and corresponding cover pool assets | Q3 2011

Total amount in issue		Nominal amount		NPV		Risk adjusted NPV	
		Q3 2011	Q3 2010	Q3 2011	Q3 2010	Q3 2011	Q3 2010
Mortgage bonds	(m EUR)	208.161,8	212.739,0	223.442,5	229.121,4	217.096,2	225.803,5
of which derivatives	(m EUR)	118,1	111,5	98,9	328,3	21,5	41,5
Cover pool	(m EUR)	270.628,5	268.770,1	292.362,9	291.236,1	276.408,1	279.606,3
of which derivatives	(m EUR)	39,4	67,0	448,8	659,4	148,5	187,7
Over-collateralization	(m EUR)	62.466,7	56.031,1	68.920,4	62.114,7	59.311,9	53.802,8
% of Pfandbriefe in issue		30,0	26,3	30,8	27,1	27,3	23,8
Total amount in issue		Nominal amount		NPV		Risk adjusted NPV	
		Q3 2011	Q3 2010	Q3 2011	Q3 2010	Q3 2011	Q3 2010
Public sector bonds	(m EUR)	357.550,7	412.924,3	391.911,3	451.833,9	362.776,9	412.786,3
of which derivatives	(m EUR)	-	-	106,6	129,4	23,2	10,8
Cover pool	(m EUR)	429.344,3	494.219,1	472.895,7	542.396,6	432.856,8	489.318,9
of which derivatives	(m EUR)	-	9,7	432,1	913,6	-	14,9
Over-collateralization	(m EUR)	71.793,6	81.294,8	80.984,4	90.562,7	70.079,9	76.532,6
% of Pfandbriefe in issue		20,1	19,7	20,7	20,0	19,3	18,5
Total amount in issue		Nominal amount		NPV		Risk adjusted NPV	
		Q3 2011	Q3 2010	Q3 2011	Q3 2010	Q3 2011	Q3 2010
Ship finance bonds	(m EUR)	7.138,9	7.591,5	7.579,2	8.014,9	7.733,7	8.122,1
of which derivatives	(m EUR)	131,1	-	188,3	18,8	185,1	18,5
Cover pool	(m EUR)	11.689,9	11.241,8	12.421,8	11.800,9	11.311,3	10.940,0
of which derivatives	(m EUR)	-	202,8	40,9	217,2	42,5	223,8
Over-collateralization	(m EUR)	4.551,0	3.650,3	4.842,6	3.786,0	3.577,6	2.817,9
% of Pfandbriefe in issue		63,7	48,1	63,9	47,2	46,3	34,7

Source: vdp, November 2011



III. Insolvency protection

- Derivatives in cover pools must enjoy and provide full protection from insolvency of the originator/covered bond issuer (if it is not a trust/SPV):
 - Insolvency of originator/manager/bank issuer must not lead to close-out of cover pool derivative.
 - Only insolvency of cover pool itself (or trust/SPV, etc.) should lead to close-out.
 - Special regime for insolvency-remoteness of cover pool (including its derivatives) of German Pfandbrief issuers
 - Cover pool derivatives share in over-collateralization in the cover pool on a pari passu basis.
- Should creditors of cover pool derivatives be pari passu with holders of covered bonds in insolvency of cover pool?
 - Incentive for counterparties to deal with cover pools and give up/limit collateral requirements.
 - Difficult to treat counterparty differently depending on whether contract is in or out of the money for them.

III. Insolvency protection

- Mechanics for ensuring insolvency protection
 - Clear legal framework for insolvency protection.
 - Separate master agreements – and, therefore, netting-arrangements – for derivatives concluded with/for the account of cover pools.
 - No “master netting“ arrangements with cover pool derivatives.
 - Possibly: registration requirements (cover pool register) also for derivatives to ensure transparency.

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