Central European Covered Bond Conference

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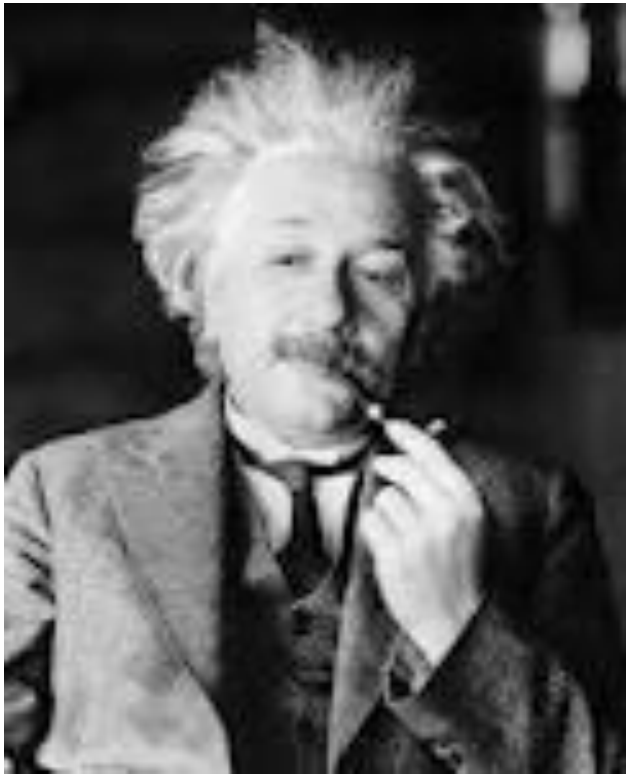
Derivatives in Cover Pools

Panel Discussion

Michael Schulz
Head of Fixed Income Research

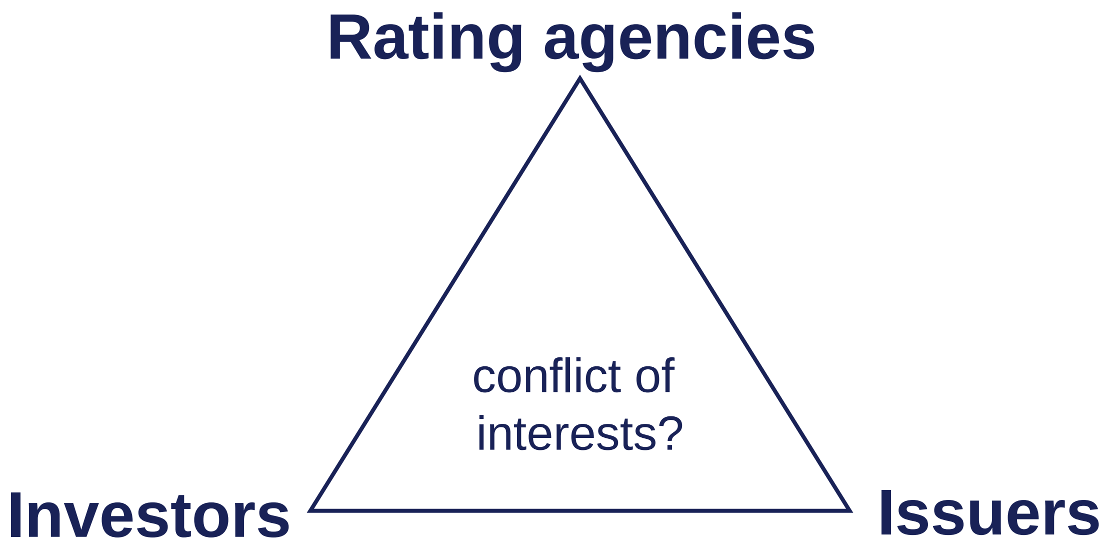
"Not everything that counts
is countable.
And not everything that
can be counted counts."

Albert Einstein



What is the purpose of having derivatives in cover pools?

- Coverage of interest and currency risks
- Closing of liquidity gaps
- Lower the need of overcollateralization to get the achieved rating
- Amending the cash flow structure



Transparency counts

Aggregated market data

- Number of covered bond programmes with derivative counterparties
  → 50
- Average number of derivative counterparties
  → 4
- Average number of third-party derivative counterparties in covered bonds
  → 9
- Minimum to maximum number of derivative counterparties in a covered bond programme
  → 1 to 35
- Average rating on derivative counterparties of covered bond programme
  → A

Source: Standard & Poor's, NORD/LB Fixed Income Research

Derivatives in cover pools permitted by statutory law

Country	Frequently used	Not frequently used
Austria		X
Denmark	X	
Finland	X	
France	X	
Germany		X
Greece		X
Hungary		X
Ireland	X	
Italy	X	
Luxembourg	X	
Netherlands	X	
Norway	X	
Poland	X	
Portugal	X	
Romania	na	na
Spain		X
UK	X	

Remark: France (OF), Denmark (SDO) / IR: Interest Rate Swaps; C: Currency Swaps; na: not applicable
Source: Covered Bond Issuers, Rating agencies, NORD/LB Fixed Income Research

EU-regulation on OTC derivative transactions (EMIR)

- Financial earthquakes like Bear Stearns (2008), Lehman (2008) and AIG resulted in an initiative for a regulated OTC-derivative market
- Published proposal for regulation of OTC-derivatives in September 2010
- The informal trilogue between Parliament, Commission and Council shall take place in November 2011 to work on the final regulation of OTC-derivatives
- Central clearing obligations for classified OTC derivative contracts between financial institutions (with standardized contracts)
- Requirements for “Central Counterparties - CCPs“ (ie: collecting sufficent margins from all counterparties and setting up a default fund)
- Bilateral exchange of collateral between the counterparties or holding of adequate capital to fulfill the margin needs of derivative transactions
- Increasing capital requirements for grandfathered OTC derivative contracts
- Derivatives the regulation applies to are interest and currency swaps (at first)

The consequences of EMIR are countable

- Clearing obligation for interest and currency swaps
  - → Regulators require standardized contracts (Bilateral changes to master agreements are forbidden)
  - → The focus on standardized derivatives and documentation contradicts the IFRS requirements for micro-hedges
  - → Derivative contracts in Covered Bond Programmes are normally collateralized in a unilateral way (In respect of the cover pool the collateralization is asymmetric)
  - → In case of an issuer insolvency counterparties rank pari passu with the covered bond investors. In this respect a bilateral exchange of collateral is not necessary
- Not only the costs of derivatives without collateral will increase. Because of EMIR the costs of unilateraly collateralized derivatives could increase dramatically in the future

Derivatives in cover pools counts

- Conflict of interests
- The market for derivatives is not very transparent
- The majority of jurisdictions allow derivatives in cover pools but…
- … only a few issuers have derivatives in the
- EMIR could cause problems for covered bo

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And not everything that can be counted counts."

Thank you very much for your attention

Michael Schulz, MBA, CIIA, CEFA
Senior Director
Head of Fixed Income Research
NORD/LB
Norddeutsche Landesbank Girozentrale
Friedrichswall 10
30159 Hannover
Tel.: +49 (0) 511 361 5309
Fax: +49 (0) 511 361 985309
Mobile: +49 (0) 172 740 4123

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