Insolvency protection of covered bonds

Payment structure, insolvency procedures, dual recouse, bail-in

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1. **Why talk about the unthinkable?**
2. Challenges
3. Liquidity risk for different payment structures
4. Consequences of payment failure
5. Impact of EU regulation
6. Summary

Why talk about the unthinkable?

Source: www.scx.hu

- Covered bonds safety net never tested
- Governments less inclined to rescue banks in future:
  - Bank Recovery and Resolution Directive (BRRD)
  - Single Resolution Mechanism (SRM)
- Further investigation into insolvency protection mechanisms by investors, regulators and rating agencies

➢ Procedures in place if needed in all cases of insolvency

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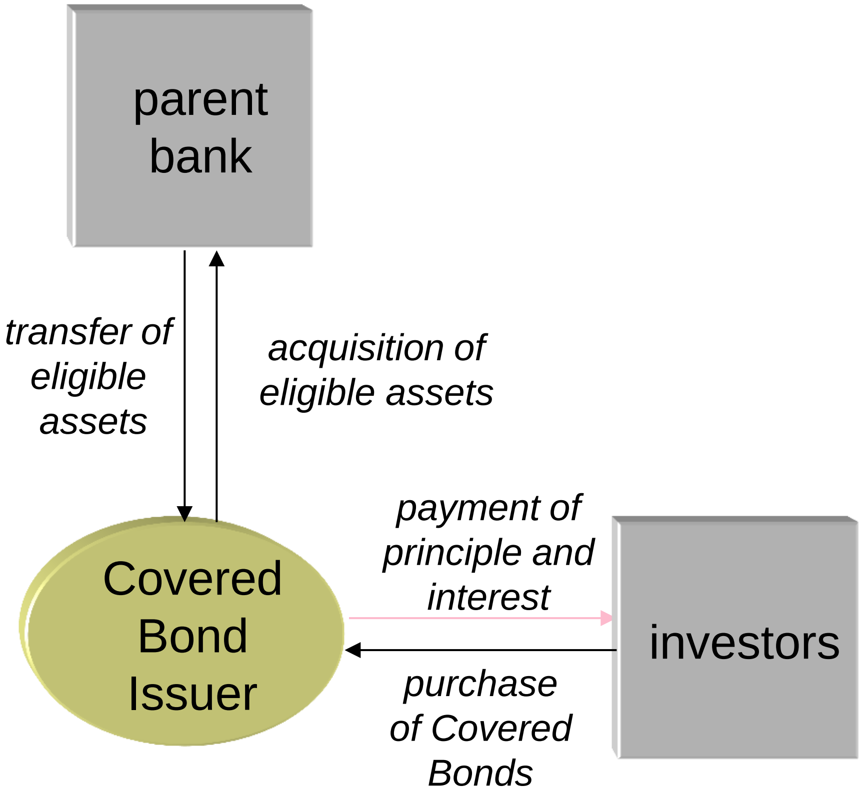
Model 1

Covered Bond issuer is a completely specialised funding institute:

France, Ireland



- Parent bank originates and services assets and manages cover pool
- Funding institute has no other function than to hold eligible assets
- Issuer has the legal status of a credit institution
- Issuer has no or almost no staff

➢ Key challenge: covered bond issuer capable of acting in spite of insolvency of parent bank?

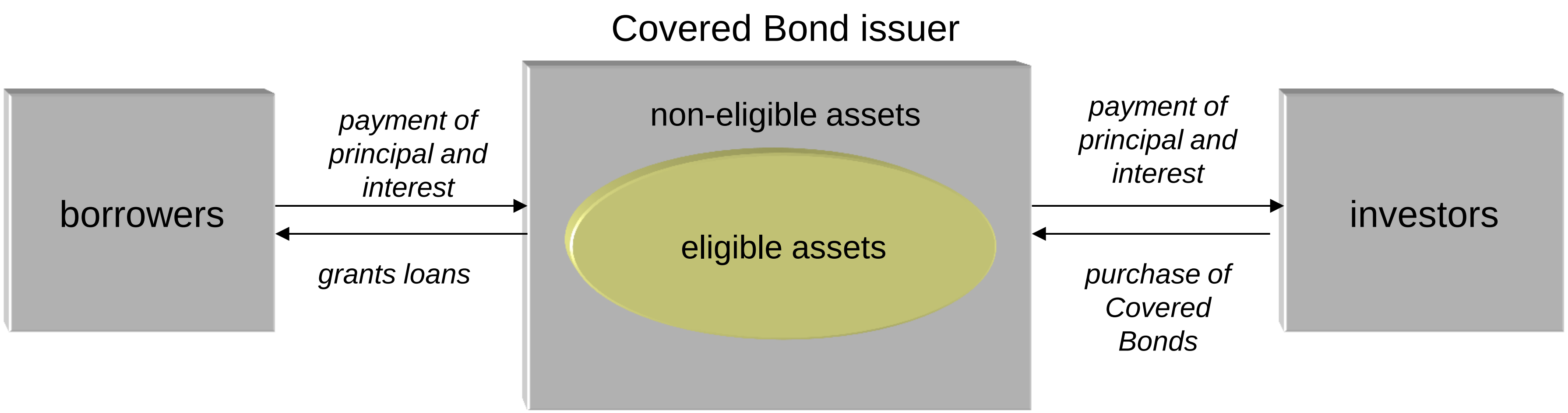
28.6.2011

Challenges (II)

Model 2

Covered Bond issuer is a specialized credit institution by law:

Denmark, Hungary, Luxemburg, Norway, Poland



- Issuer originates, services and funds eligible and non-eligible business
- Loan origination restricted by law to mortgages and public-sector loans
- Issuer has the legal status of a credit institution

➢ Key challenge: insolvency segregation of cover assets from insolvency estate

Challenges (III)

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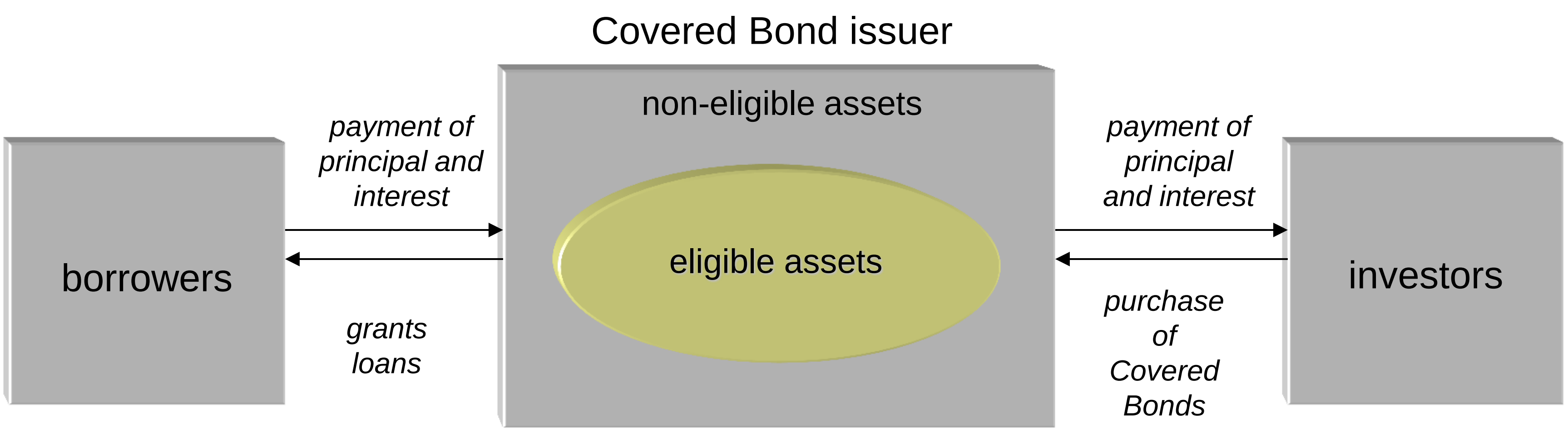
Model 3

Covered Bond issuer is a universal credit institution

Austria, Belgium, Bulgaria, Czech Republic, Cyprus, Finland, Germany, Greece, Iceland, Latvia, Lithuania, Portugal, Romania, Russia, Slovakia, Slovenia, Spain, Sweden



- Issuer originates, services and funds eligible and non-eligible business
- Strict eligibility criteria apply to eligible cover assets
- Issuance governed by special legal framework

➢ Key challenge: insolvency segregation of cover assets from insolvency estate

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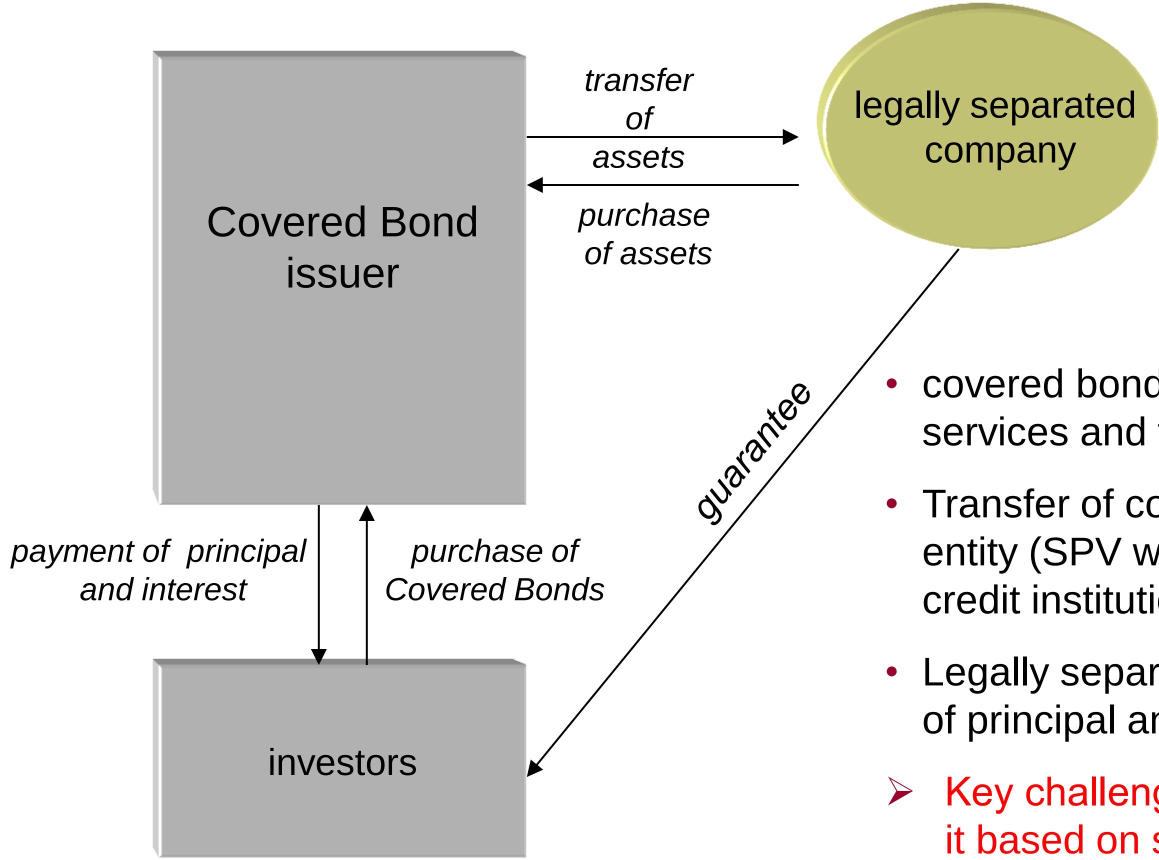
Model 4

Covered Bond issuer uses SPV to achieve insolvency segregation of cover assets:

Italy, Netherlands, UK



- covered bond issuer (credit institution) originates, services and funds eligible & non-eligible loans
- Transfer of cover pool assets onto legally separated entity (SPV without legal status of credit institution)
- Legally separated entity guarantees payment of principal and interest

➢ Key challenge: How is asset “transfer” achieved? Is it based on special legal framework? Will transfer survive issuer’s insolvency?

Additional challenges and mitigations:

- Over-indebtedness (credit risk)
  - ➢ High quality requirements for cover assets
- Inability to pay (liquidity risk)
  - ➢ Liquid cover assets
  - ➢ Access to liquidity resources like central bank liquidity (cover assets eligible as collateral?)
  - ➢ Flexibility for cover pool administrator via soft-bullet or pass-through structures
  - ➢ Other solutions like moratorium, creditor's meeting or debt restructuring?

For rating agencies liquidity risk plays a very important role:

- Fitch
  - Separate D-Component “Liquidity gap and systemic risk”, which in many cases belongs to the weakest components
- Moody’s
  - Timely Payment Indicator (TPI) is - among other factors - driven by liquidity risk
- Standard & Poor’s
  - Asset Liability Mismatch (ALMM) at the heart of Covered Bond rating methodology

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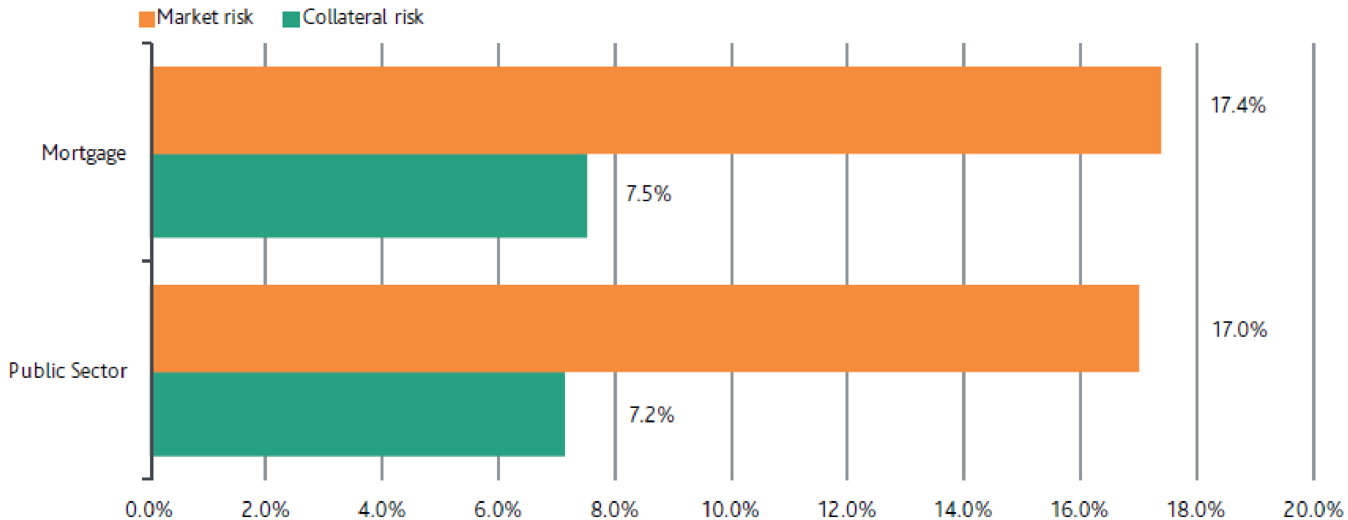
For rating agencies liquidity risk plays a very important role:

Simple Average Cover Pool Losses by Asset Type



Source: Moody's

- Liquidity risk is a major driver for overcollateralization (OC) requirements

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Liquidity risk for different payment structures (I)

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Hard-bullet

Highest liquidity risk with hard-bullets due to promise to pay at fixed maturity

- Other risk mitigation factors like liquidity buffer needed
  - Sufficient?
  - Expensive
  - Acknowledged by rating agencies?

Soft-bullet

By giving the cover pool administrator more flexibility soft-bullets mitigate liquidity risk

- Contractual?
  - When can the provision be used? What are the consequences?
  - Clear and transparent documentation?
- Legal basis in covered bond law?
  - Distinct and comprehensive regulations?
  - So far not existent
  - If new requirement => for all outstanding or for new issues only?

Pass-through

The only way to eliminate liquidity risk completely

- So far only on contractual basis; no legal basis in covered bond law
- For a long time reserved for retained covered bonds
- Do investors buy pass-through structures?
  - Commerzbank SME bond
  - „Conditional“ pass-through of NIBC
- Still perceived as a covered bond?

Investor

Supervisory authority, EU-law, ECB

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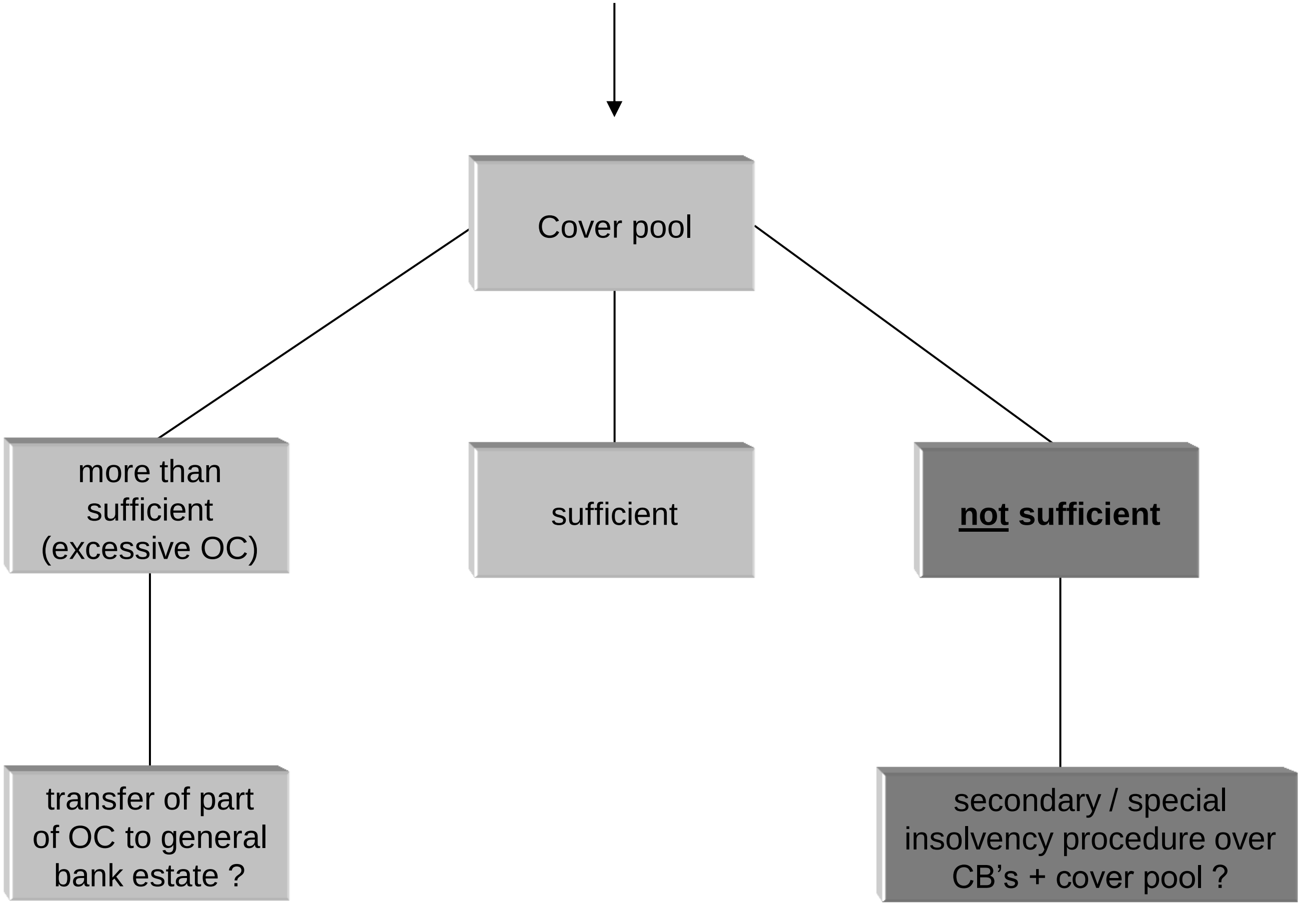
Consequences of payment failure (I)

Precondition: Covered Bond issuer’s insolvency



Secondary / special insolvency procedure over Covered Bonds/ cover pool?

Provision in covered bond law?

Yes

- Insolvency law?
- National Securities Law (Meeting of Creditors,…)?
- Other specifications?

➢ „Regulated“ Insolvency?

No

- General (bank-) insolvency law?
- Contractual agreements?

➢ „Unregulated“ Insolvency?

Any rights of intervention (BRRD, SRM)?

Consequences of payment failure (III)

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Dual recourse?

During life time of issuer:
First claim on issuer, second on cover pool

After issuer‘s insolvency:
First claim on cover pool, second on insolvency estate

Is there any value in the second claim (specialised subsidiary)?
How to apply for claim, when and who to?
How to ensure recourse on insolvency estate, if last covered bond matures in 50 years?

Is the second Dual recourse justified at all?

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How will EU regulation affect insolvency protection/procedures?

Bank Recovery and Resolution Directive

- ✓ No bail-In for covered bonds
- Threat through valuation? (2nd Bail-In)
- Claim against restructured bank still in place?

Single Resolution Mechanism

- Who decides on issuer‘s insolvency?
- Who decides on cover pool bail-in and insolvency?
- Which rules are the decisions based on?
- Covered bond definition?
- Could regulators prefer an early separation of covered bonds from the credit institution?

➢ Will national covered bond laws have any relevance in the future at all?

Impact of EU regulation (II)

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European Banking Union

S R M

Single Resolution Mechanism

- regulation -

S S M

Single Supervisory Mechanism

- regulation -

<u>Treatment of covered bonds</u>

- Definition (UCITS v. CRR)
- Exclusion from bail-in
- Nat. discretion for partial write-down, if lack of coverage (“2nd bail-in”)
- special supervision

BRRD

(Bank Recovery and Resolution Directive)
Resolution instruments / tool box
• valuation • bail-in • minimum bail-inable liabilities

➢ Need to harmonize CB definitions / criteria in all EU legislation?!

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Summary

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- Covered bond safety net not tested so far
- Governments less inclined to rescue banks
- Insolvency protection mechanisms and procedures need to be in place
- Specific challenges for covered bond models
- Credit and liquidity risk relevant for any covered bond
- Liquidity risk is key
- Many ways to mitigate liquidity risk, pass-through perfect solution?
- Unintended pass-through covered bonds due to lack of policies for cover pool insolvency?
- How important and realistic is dual recourse?
- EU regulation will have a great impact on covered bond systems

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