

Covered bond creditors vs. unsecured creditors

Vienna, October 2010

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Regular collateral vs. over-collateral

Status of secured and unsecured creditors

In case of insolvency ALL creditors have the full right to claim the nominal amount of their debt claims

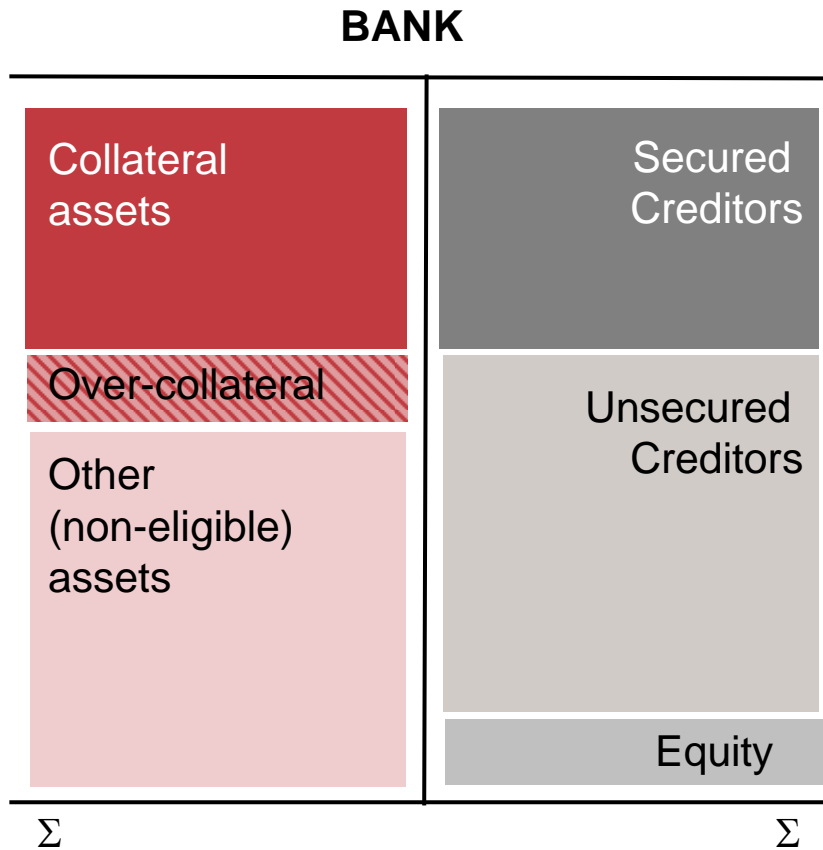
Unsecured Creditors

- Claim against all (non-reserved) assets
- Difference in ranking (senior vs junior or subordinated)

Secured Creditors

- First claim on a dedicated pool of (high quality) assets
- **Excess-collateral** available to unsecured creditors
- Shortfalls would rank *pari-passu* with unsecured creditors
- Particularly banks ask for collateralisation of their claims these days
- Standardised collateralisation agreements
- Classical examples:
 - collateralised lending
 - repurchase agreements (repos)
 - derivative contract
 - covered bonds

The conflict between unsecured and secured creditors



Potential of Conflict

- Structural subordination of unsecured creditors
 - **Volume** of assets available
 - **Quality** of assets available
 - **Disclosure** about reservation of assets
 - **Timing** of availability of excess collateral

Collateralisation of covered bonds

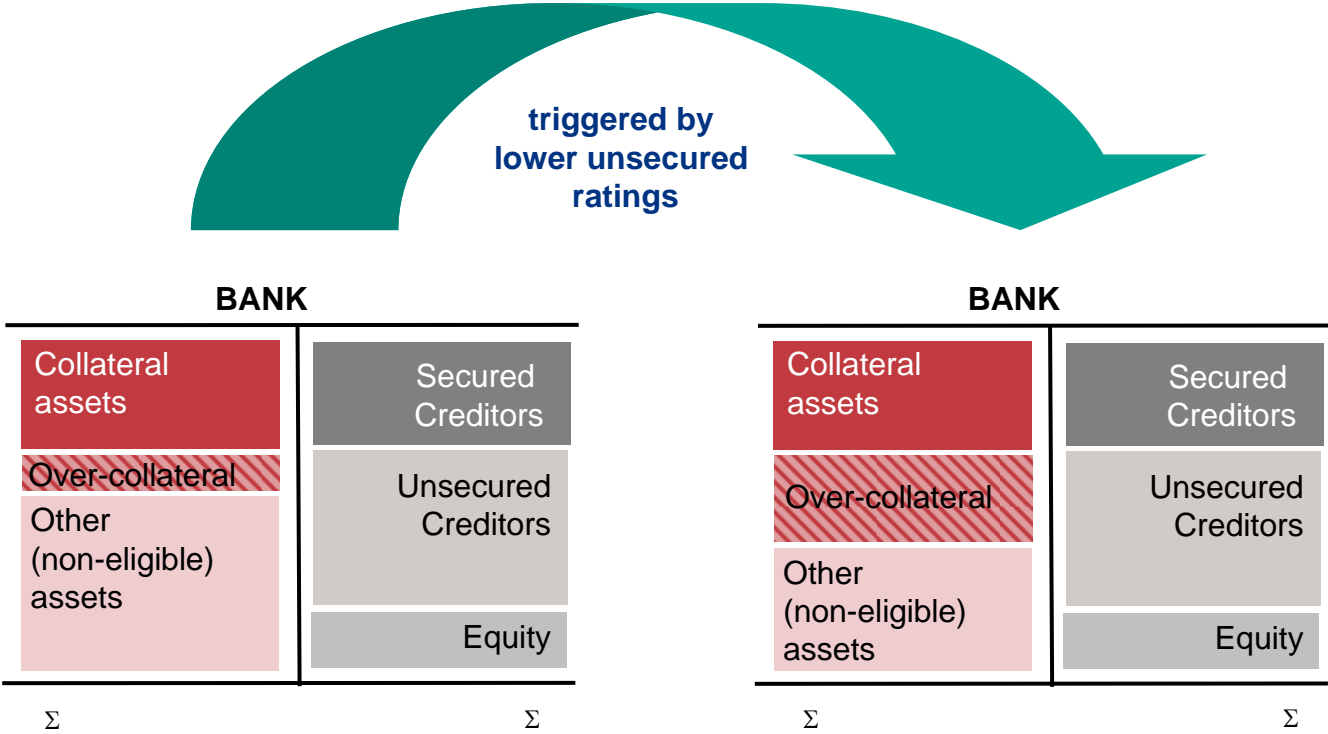
Collateralisation is THE core element of covered bonds

- Explicit over-collateralisation if something more modern and recently introduced
- Over-collateralisation could be provided
 - implicitly via a relatively low loan-to-value of the collateral assets and/or conservative valuation methodology
 - explicitly via a volume of collateral assets exceeding the nominal amount of claims
- Over-collateralisation is (currently) used to address:
 - Quality requirements (UCITS 52/4 - NL)
 - Costs arising following issuer default
 - Credit risk
 - Liquidity risk
 - Market risks

AND ...

Collateralisation of covered bonds (cont'd)

- the credit quality of the issuer

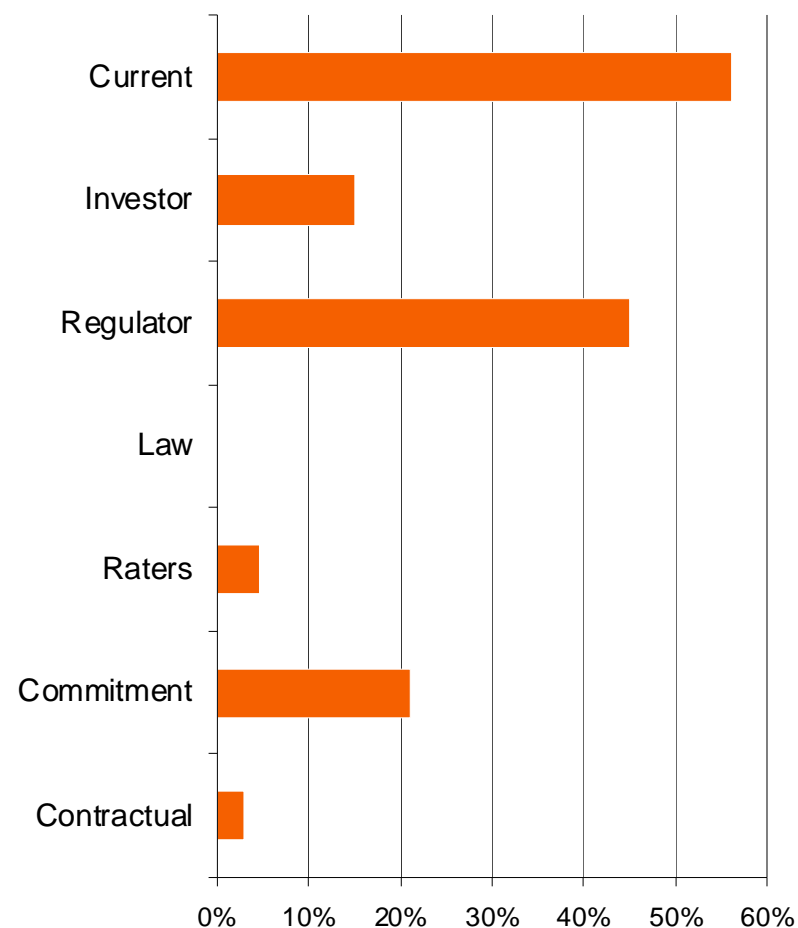


Who requires over-collateralisation

Over-collateralisation can be required by

- Rating agencies
 - Investors
 - Legal guidelines
 - Regulators (incl. central banks – at least indirectly)
 - Trustees
- Everyone of these institutions has its own agenda which could result in OC requirements to notably differ

OC levels for ING's Dutch covered bonds



Source: RBS, Moody's, Fitch, as of Oct 2010

Who Requires over-collateralisation (cont'd)

Threats to covered bond holders in case of issuer default:

- is the (over-) collateralisation (OC) still sufficient to cover all relevant costs and risks
- are only relevant risks addressed through OC (referring to credit risks)?

Questions raised:

- Which OC requirement is the relevant one in case of issuer default?
- How much OC is really needed (and finally available)?
- Is there a need for particular legal regulations concerning the protection and bankruptcy remoteness of OC?

The uncertainty of the dynamic nature of (over-) collateralisation

The risk to covered bond holders are exposed to:

Rapid DECREASE of over-collateralisation due to

- lower target rating
- higher / additional funding volume against constant level of nominal (over-) collateral available

Rapid INCREASE in over-collateralisation in order to

- keep target rating
- Ensure investor confidence

Unsecured investors are exposed to these changes without having any means to oppose them

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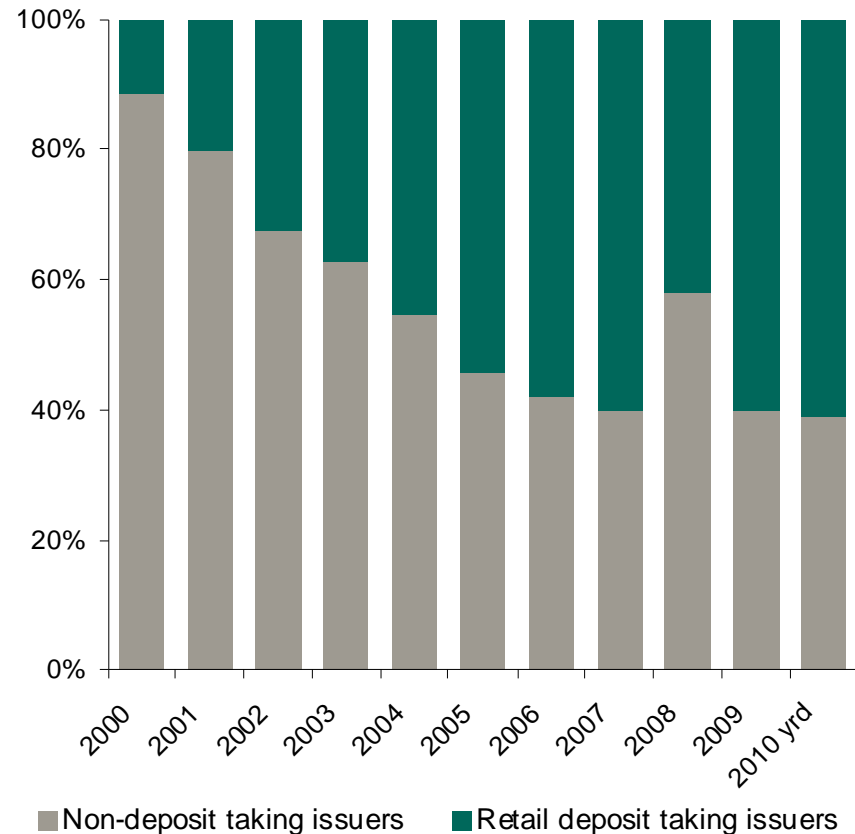
(Potential) third Party claims on over-collateral following issuer default

Deposit Protection Schemes (DPS)

Why DPS?

- Trend away from special bank principle toward the general bank principle
- Protection of creditors other than only retail depositors (e.g. Schuldscheine)
- DPS have already been very actively involved in saving covered bond issuers (e.g. Germany)

Primary market share of deposit taking vs. non-deposit taking Jumbo CB issuers



Source: RBS as of Oct 2010

RBS8145

DPS within the EU

- The system of DPS in Europe is split between
 - Public DPS provided by the country or the central government
(On the back of the GFC it was agreed to raise the sum per retail depositor guaranteed by national public DPS within the EU to € 100k)
 - DPS provided by private organisations in access to what is protected by the government
 - In total in EU more than 40 different DPS even though only 27 different countries

DPS can be very important counterparts raising claims against a CB issuers

Position of DPS (cont'd)

Position of the DPS upon issuer default:

- forced to bail out depositors when need be
- aim to recover the money paid from claiming on the assets of the insolvent estate
- high interest to (quickly) get access to as many (high quality and highly liquid) assets as possible
- probably challenging any possible (over-) collateral agreement existing



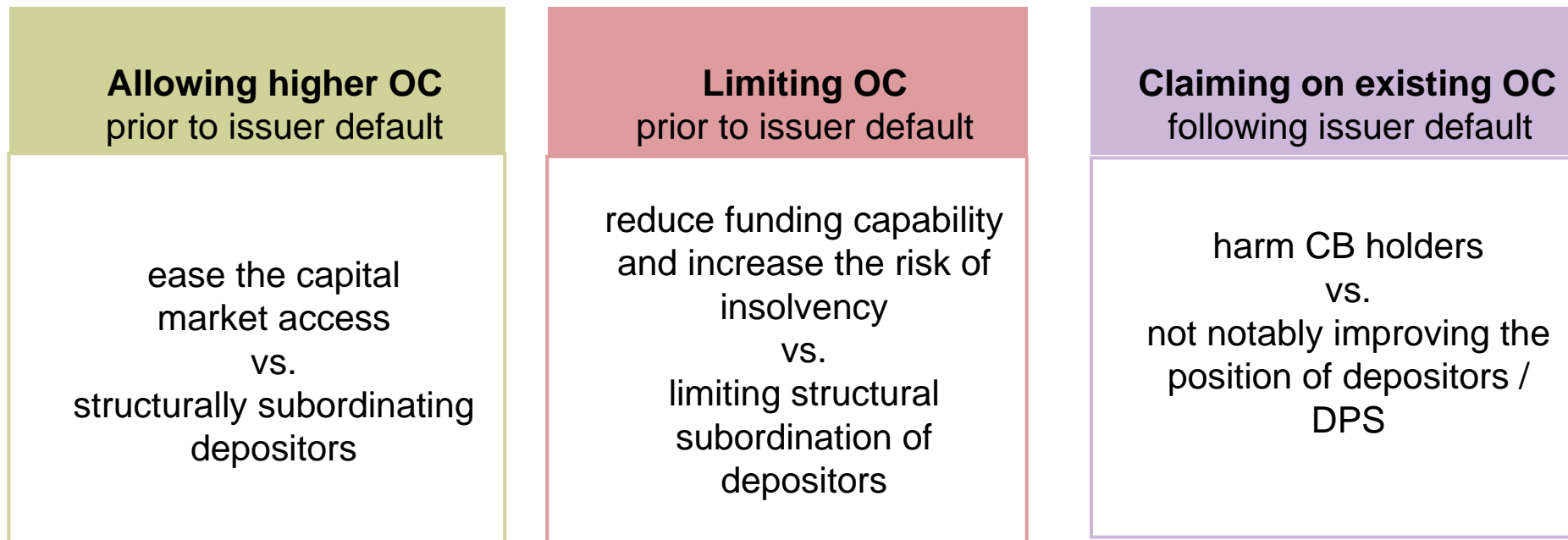
The same government that initially established a legal framework for covered bonds that protect OC might question the respective agreements in case of issuer default through its DPC system



Dilemma of DPS (cont'd)

Dilemma of the DPS: Issuer protection vs. depositor protection

- Traditionally private DPS feel equally exposed to both
- Most recent suggestions of the EU are indication an intention to focus on both more equally in the future



Unsecured creditors vs. CB holders – potential conflicts I

Status of the insolvency administrator raising the claim on behalf of unsecured creditors:

- Separate from the cover pool administrator
 - need to sort out their claims, potentially even in court
- Both administrators are the same
 - potential conflict of interest
 - position of both creditors may be unclear
 - CB holders may face less protection

Unsecured creditors vs. CB holders – potential conflicts II

The asymmetric interest and flow of payments between both creditors

Unsecured creditors

- expect the bulk of their recovery payments as soon as possible irrespective of the initial tenor of their claims
- Dislike to wait for the CBs to mature to get access to potential (excess) OC

Covered bond holders

- get their money at initial maturity and nothing beforehand
- OC might be needed any time during the whole period until the last CB matures
- Like to see OC protected until the last CB has matured

Dilemma

Reduction of OC at the beginning of the insolvency process might prove to be a wrong decision in the long run

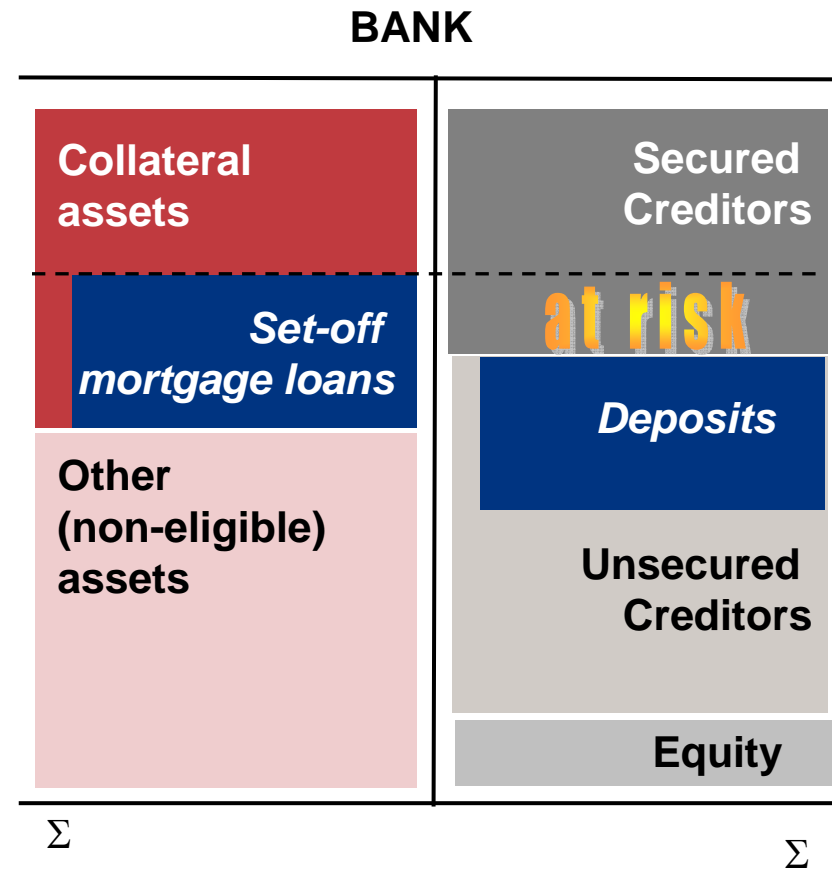
vs.

The fair level of protection (**OC**) for covered bond holders

Depositors and the right of set off

What is “right of set off”?

- It is the right borrowers (mortgagors) might have in case of insolvency of a financial institution to offset their payment obligations with claims such as deposits they have against this particular insolvent estate.
- Special problem where applicable law does not recognise the exclusion of set-off (by statute or contract) in the country the issuer is incorporated
- Potentially resulting in reduced assets availability for covered bondholders.



Depositors and the right of set off - where excluded

Germany

- Set-off is legally excluded
- No need to notify mortgagors about registration of their mortgages as collateral
- Does not mean that there would be no legal uncertainty in case of issuer insolvency

Austria

- Set off is legally excluded
- Need to notify mortgagors in case of registration of mortgage loans as collateral about exclusion of set-off
- Following the notification mortgagors have the right to move their deposits but they have no right to pre-pay the mortgage.
- Problem in case of sale of larger mortgage portfolios

France (OF), Norway and Ireland

- Issuers cannot take deposits

Depositors and the right of set off - where possible

Sweden

- Mortgagors have the right of set-off
- “THE ISSUER intends to ensure that the nominal value of the assets in the Cover Pool will at all times exceed the nominal value of claims that may be asserted against THE ISSUER in relation to the Covered Bonds.” (out of prospectus)

Italy, Portugal, UK, Greece, The Netherlands

- Mortgagors have the right of set-off
- Risk of set-off is addressed in the Asset Coverage Test
- „Set-off risk is the minimum between the outstanding on the loan and the deposits in the current account (+ other liabilities towards that borrower, see below definition of Individual Net Deposits)”
- Subtraction of this minimum amount from the assets available in the cover pool

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