

3.18 THE NETHERLANDS

By Daniëlle Boerendans, ABN AMRO Bank N.V.
Rezah Stegeman, Clifford Chance LLP
and Kees Westermann, Linklaters LLP

I. FRAMEWORK

The Dutch regulation for covered bonds (the "**Regulation**") came into force in the Netherlands on 1 July 2008 and aims to:

- > provide Dutch issuers with a level playing field with other issuers of covered bonds within the European Union;
- > facilitate a market in safe instruments in accordance with the applicable European directives; and
- > impose solid conditions to protect covered bondholder interests.

The Regulation embraces a segregated structure, being a structure where the cover assets are segregated from the issuer and owned by a covered bond company (the "**CBC**"). Under the Regulation, asset segregation takes place on the basis of the Dutch Civil and Bankruptcy Codes. The applicable statutory provisions are relatively creditor-friendly and have enabled the Dutch legislator to take a time-efficient and principle-based approach without having to amend the Dutch Civil or Bankruptcy Code.

The Regulation is not a separate instrument but a collection of rules forming part of the following two layers of secondary legislation implementing the Dutch Financial Supervision Act (Wet op het financieel toezicht; the "**FSA**"):

- > the FSA Prudential Rules Decree (*Besluit prudentieel toezicht Wft*); and
- > the FSA Implementing Regulation (*Uitvoeringsregeling Wft*).

There is however a third Dutch regulation which contains specific covered bond provisions, being the Regulation on Solvency Requirements for Credit Risk and Large Exposures FSA 2010 (*Regeling solvabiliteitseisen kredietrisico en grote posities Wft 2010*; the "**Solvency Requirements FSA**"). An important distinction to bear in mind is that the Regulation focuses on issuance of covered bonds by Dutch banks out of The Netherlands (which is what this chapter is about), whereas the relevant Solvency Requirements FSA focus on investment by Dutch banks (and investment firms) in covered bonds issued out of any country that is a party to the European Economic Area. The relevant Solvency Requirements FSA are a number of years older than the Regulation and stipulate the regulatory beneficial treatment for investments in covered bonds that are backed by CRD-compliant assets. CRD-compliant assets are basically assets that meet the requirements of item 68 of Annex VI to the Banking Consolidation Directive (2006/48/EC; the "**BCD**"), which together with the Capital Adequacy Directive (2006/49/EC) constitutes the Capital Requirements Directive (the "**CRD**").

II. STRUCTURE OF THE ISSUER

Under the Regulation the issuer needs to be a bank (that is a credit institution as meant in article 4(1) (a) BCD) that is licensed by the Dutch Central Bank (*De Nederlandsche Bank N.V.*; "**DNB**"). General banking supervision by DNB on the solvency, liquidity, business operations et cetera of the issuer falls outside the scope of this chapter.

The covered bonds are guaranteed by the CBC owning the cover assets, thus creating dual recourse for the covered bondholders. The CBC is a special purpose vehicle set up as a bankruptcy-remote, orphan entity, as follows. It is a private company with limited liability (*besloten vennootschap met beperkte aansprakelijkheid*) wholly owned by a foundation (*stichting*), with independent directors provided by a corporate services provider and no employees. It has a limited corporate objects clause, so that any third party dealing with the CBC will be able to see that it is dealing with a special purpose vehicle. Non-petition and limited recourse wording is agreed with all transaction parties that are creditors of the CBC under the transaction documents. Any remaining third party creditors not signing up to such non-petition and limited recourse provisions are listed high in the relevant priority of payments, so as to procure they are timely paid. An insolvency of the issuer does in itself not result in an insolvency of the CBC.

The cover assets are owned by the CBC, but from an accounting perspective the assets remain on the consolidated balance sheet of the issuer, which continues to carry the credit risk of the cover assets. The CBC pledges the cover assets to a security trustee, which is a foundation especially established to act as a security trustee in relation to the relevant covered bonds. The security trustee receives the rights of pledge in its own name, but acts in the interest of the covered bondholders and certain other transaction parties that are creditors of the CBC.

III. COVER ASSETS

To date all Dutch covered bond programmes (i.e. ABN AMRO, Achmea, ING, NIBC and SNS) are backed by residential mortgage loans. In addition they allow for inclusion of substitution assets, meaning euro-denominated:

- > cash; or
- > other assets eligible under the CRD to collateralise covered bonds, subject to minimum rating and maximum percentage requirements (this differs per programme).

All programmes allow for inclusion of non-Dutch residential mortgage loans, subject to certain restrictions. In practice all cover pools consist of Dutch residential mortgage loans and, in one programme, German residential mortgage loans.

Although the Solvency Requirements FSA contain detailed provisions on cover assets as prescribed by the CRD, the Regulation only lists the general requirements of article 52(4) of the Undertakings for Collective Investment in Transferable Securities Directive (85/11/EC; "UCITS"). The Regulation therefore regards CRD-compliance as an option, and not as a requirement. It allows issuers of (and thus investors in) Dutch covered bonds the flexibility to choose whether they wish to issue (or invest in) covered bonds which are either:

- > UCITS-compliant; or
- > both UCITS- and CRD-compliant.

The ABN AMRO, ING, NIBC and SNS covered bond programmes are designed to be both UCITS- and CRD-compliant. The Achmea covered bond programme is designed to be both UCITS- and CRD-compliant in all respects but one: it applies a 125% rather than an 80% LTV Cut-Off Percentage. This will be explained in more detail in paragraph IV below.

UCITS- and CRD-compliance of Dutch covered bonds can only be achieved if the relevant covered bonds are registered by DNB under the Regulation. The DNB register indicates whether the relevant covered

bonds are CRD-compliant. All covered bonds registered by DNB are in principle UCITS-compliant. The requirements for, and status of, registration of Dutch covered bond programmes will be set out in paragraph VI below.

IV. VALUATION AND LTV CRITERIA

The above feature of CRD-compliance as an option, should be seen against the background that the CRD prescribes that covered bonds may be backed by residential mortgage loans only up to the lesser of (a) the principal amount of the relevant mortgage right and (b) 80% of the value of the underlying mortgaged property. However, relevant Dutch residential mortgage loans may in practice have a loan-to-value ("**LTV**") ratio of up to 125%. To date all Dutch covered bond programmes take a two-step approach towards LTV-ratio's of Dutch residential mortgage loans, as follows:

- > the loan is only eligible as cover asset if the LTV-ratio did not exceed 125% (subject to some exceptions in some programmes; the "**Eligibility Percentage**") at origination; and
- > once a loan forms part of the cover assets, the maximum value attributed to it in valuing the cover assets is a certain percentage (this differs per programme; the "**LTV Cut-Off Percentage**") of the value of the underlying mortgaged property at such time. For example, if (a) the relevant LTV Cut-Off Percentage is 80% and (b) a residential mortgage loan has a principal amount of 110 and is backed by mortgaged property with a value of 100, then such loan would be valued at no more than 80 in the asset cover test determining the value of the cover assets. The 30 excess value of the loan would serve as extra credit enhancement in Dutch covered bond programmes. This would not be the case in integrated covered bond structures used in countries that apply prescriptive (that is rule-based rather than principle-based) regulations.

The LTV Cut-Off Percentage applied to Dutch residential mortgage loans is:

- > 80% in Dutch covered bond programmes which are designed to be backed by CRD-compliant cover assets (i.e. ABN AMRO, ING, NIBC and SNS);
- > 125% in Dutch covered bond programmes which are not designed to be backed by CRD-compliant cover assets (i.e. Achmea); and
- > notwithstanding the percentages mentioned in the previous two paragraphs, 100% or a different percentage for residential mortgage loans that have the benefit of a Dutch National Mortgage Guarantee (*Nationale Hypotheek Garantie*).

The Regulation does not (nor does the CRD) prescribe whether it is the foreclosure value or the market value of the underlying mortgaged property which should be taken into account when calculating the LTV-ratio. To date under the Dutch covered bond programmes:

- > the Eligibility Percentage is applied to the foreclosure value at origination; and
- > the LTV Cut-Off Percentage is applied to the market value of the mortgaged property at the relevant time which is set at 85-90% (this differs per programme) of the applicable foreclosure value at origination, subject to indexation. As to indexation, (a) if prices go up, the property value is increased by 85-100% (this differs per programme) of the increase and (b) if prices go down, the value is reduced by 100% of the decrease.

V. ASSET - LIABILITY MANAGEMENT

Under all current Dutch covered bond programmes a total return swap is entered into at inception of the programme in relation to the cover assets. The total return swap basically swaps the different types of interest to be received on the cover assets to 1 month's EURIBOR. In addition, an interest rate swap or structured swap is entered into each time a series of covered bonds is issued. The interest rate/structured swap basically swaps the aforementioned 1 month's EURIBOR/euro's to the interest rate/currency payable under the relevant series of covered bonds.

All Dutch covered bond programmes require the issuer to establish a reserve fund equal to 3 month's interest payments on the covered bonds plus certain costs and expenses for 1 month if the issuer's short term rating is or falls below P-1/F1/A-1 or A-1+ (this differs per programme).

To mitigate liquidity risk on principal payments all Dutch covered bond programmes use either:

- > a pre-maturity test which is taken on each business day during 6 or 12 months preceding the maturity of the relevant covered bonds (depending on the programme and the rating agencies involved). The pre-maturity test is failed if on the relevant test date the issuer's short term rating is or falls below P-1/F1+/A-1+. A breach of the pre-maturity test requires (a) the issuer to cash-collateralise hard bullet maturities or (b) the CBC to procure alternative remedies such as a guarantee of the issuer's obligations, a liquidity facility and/or a sale or refinancing of cover assets; or
- > a one-year maturity extension. The possible extension applies only to the CBC and only to any final redemption amount payable by the CBC in relation to a series of covered bonds under the guarantee.

For all Dutch covered bond programmes a minimum level of over-collateralisation is required, which is measured by applying an asset cover test with asset percentages ranging from approximately 70 to 85%.

VI. COVER POOL MONITOR AND BANKING SUPERVISION

Under all Dutch covered bond programmes the issuer is obliged to frequently send out investor reports that contain detailed information about, among other things, the cover assets and the performance of a monthly asset cover test. The accuracy of the asset cover test calculation is required to be tested at least annually by an independent auditor. Each year the CBC is required to produce audited financial statements.

When reviewing a Dutch covered bond programme submitted to it for registration under the Regulation, DNB requires:

- > a valid safeguard valid safeguarding of sufficient cover assets for the covered bondholders. The assets must be validly transferred by the issuer to the CBC and pledged by the CBC to the security trustee;
- > the covered bonds to have a credit rating of at least AA-/Aa3;
- > a healthy ratio between the programme/issuance amount on the one hand and on the other hand (a) the value of the cover assets, (b) the value of the remaining assets of the issuer eligible for addition to the cover assets and (c) the consolidated balance sheet of the issuer (the latter to protect other stakeholders); and
- > the issuer to have solid and for verifying and procuring the sufficiency of the cover assets, taking into account the composition of the cover assets, the over-collateralisation and the applicable risks and stress tests.

To date the ABN AMRO, ING, NIBC and SNS covered bond programmes have been registered by DNB. The register is available on-line and can be found at <http://www.toezicht.dnb.nl/en/2/2/51-202602.jsp> (click on: Searching in the register).

Once a Dutch covered bond programme is registered by DNB, the issuer will have ongoing administration and reporting obligations towards DNB. If the covered bonds no longer meet the requirements set by the Regulation or if the issuer no longer complies with its ongoing administration and reporting obligations towards DNB, there are likely to be short communication lines between the issuer and DNB. If it comes to sanctions, it may be that an issuance-stop is imposed on the issuer, which may be disclosed by DNB in its register. DNB is entitled to ultimately strike the registration of a covered bond. In practice it is not very likely that DNB would ever exercise its deregistration authority. Apart from verbal assurance this is confirmed by the explanatory notes to the Regulation, which in short state:

- > that deregistration will only occur (a) after due consideration of the interests of the issuer and the covered bondholders and (b) in the exceptional circumstance that DNB's supervision is no longer in the interest of the issuer and no longer grants protection to covered bondholders; and
- > that the interests of the issuer and the covered bondholders include that the registration and supervision be maintained.

VII. HOW ARE SEGREGATION OF COVER ASSETS AND BANKRUPTCY REMOTENESS OF COVERED BONDS REGULATED?

The regulations enabling the segregation of the cover assets and bankruptcy-remoteness of the CBC are set out in the Dutch Civil and Bankruptcy Codes.

VIII. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

As explained above, Dutch covered bonds registered by DNB under the Regulation are registered either as UCITS-compliant or as UCITS- and CRD-compliant. Dutch covered bonds which are not registered under the Regulation are neither UCITS- nor CRD-compliant.

It differs per type of investor whether investing in a certain category of covered bonds provides regulatory special treatment. For ease of reference such regulatory treatment (for Dutch financial institutions) is set out in more detail below, focusing on Dutch covered bonds registered under the Regulation:

Dutch covered bond category Type of investor		UCITS -compliant	UCITS- and CRD-compliant
UCITS and insurers		Higher investment limits	Higher investment limits
Banks and investment firms using:	Standardised Approach	None	- Lower risk weighting
	Foundation Internal Ratings Based (IRB) Approach	None	- Lower loss given default value

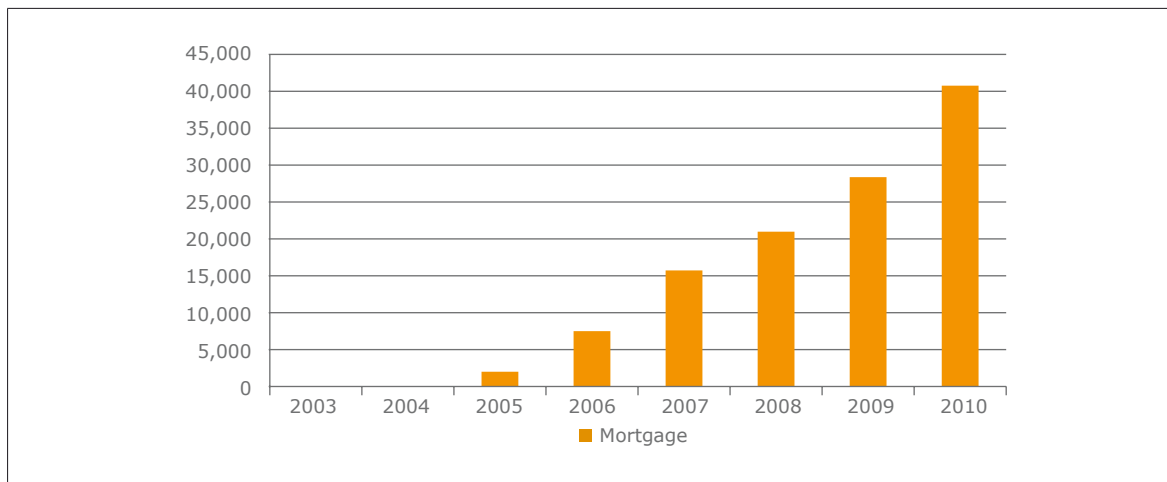
A further regulatory special treatment which is not reflected in the above diagram, is available to CRD-compliant Dutch covered bonds in the context of banks and investment firms entering into repurchase transactions (repo's) with the Dutch covered bond issuing banks. If the issuing Dutch bank posts its own CRD-compliant covered bonds as collateral under the repo, then such covered bonds qualify as financial collateral under the Solvency Requirements FSA for the purpose of mitigating the credit risk

of the bank/investment firm on the issuing Dutch bank as its repo counterparty if such covered bonds are CRD-compliant.

Finally, if Dutch covered bonds are UCITS-compliant, they receive special treatment from the European Central Bank (“**ECB**”) in determining their eligibility for monetary policy operations (such as the marginal lending facility to obtain overnight liquidity from national central banks), including:

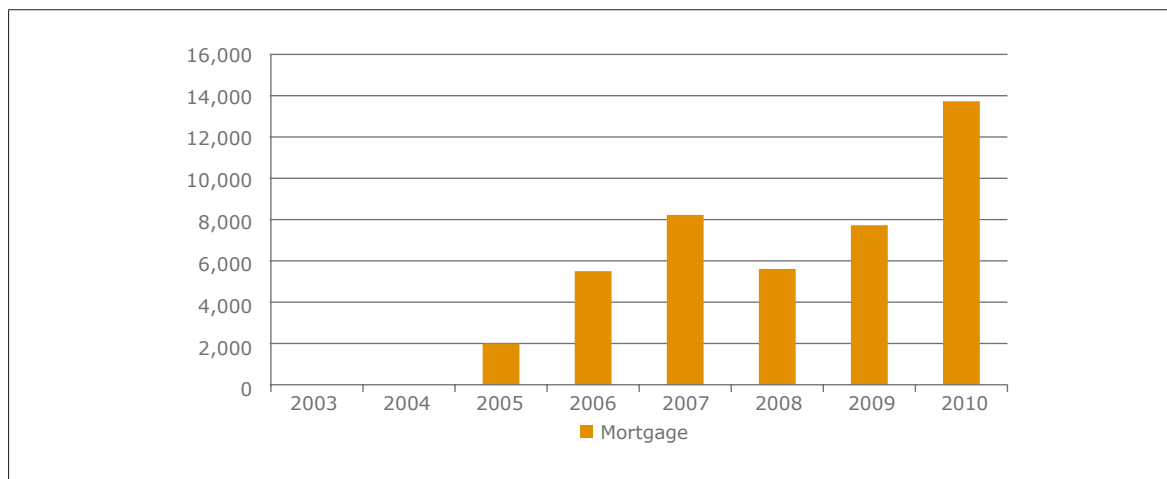
- > they are eligible even where the posting bank is the issuer (or has ‘close links’ with the issuer or guarantor) of the covered bonds. This means for example that a Dutch bank wishing to borrow from DNB may use its own UCITS-compliant covered bonds as collateral (informal assurance suggests that CRD-compliance is currently not required and that ‘own’ general-law-based covered bonds will not be accepted);
- > they need not be admitted to trading on a regulated market (as defined in the Markets in Financial Instruments Directive; MiFID); and
- > unlike other asset-backed securities:
 - (a) they are not eligible for an exemption from the general rule that debt instruments must have a fixed, unconditional principal amount;
 - (b) they may be backed by credit-linked notes or similar claims resulting from the transfer of credit risk by means of credit derivatives; and
 - (c) they are exempt from certain true sale requirements. In addition, if issued prior to 1 January 2008, they are exempt from certain credit quality thresholds. However, these exemptions are of lesser relevance for Dutch UCITS-compliant covered bonds because the Regulation requires a segregated structure as well as a credit rating of at least AA-/Aa3.

> FIGURE 1: COVERED BONDS OUTSTANDING, 2003-2010, EUR M



Source: EMF/ECBC

> FIGURE 2: COVERED BONDS ISSUANCE, 2003-2010, EUR M



Source: EMF/ECBC

Issuers: There are five issuers in the Netherlands: ABN AMRO Bank N.V., Achmea Hypotheekbank N.V., ING Bank N.V., NIBC Bank N.V. and SNS Bank N.V.. Except for Achmea all issuers are registered at DNB.