

Revised Dutch legislative framework for registered covered bonds

What investors and other market participants should know

On 1 January 2015 a revised legislative framework relating to registered covered bonds came into force in the Netherlands (2015 CB Legislation). The 2015 CB Legislation contains newly introduced cover asset quantity and quality, liquidity buffer and audit requirements and reporting undertakings for issuing banks for the benefit of investors. It also takes into account the best practices identified by the European Banking Authority (EBA) in its report "EBA Report on EU Covered Bond Frameworks and Capital Treatment" of 1 July 2014. Clifford Chance was involved in the consultation process of the 2015 CB Legislation.

A Dutch covered bond registered under the 2015 CB Legislation will comply with the conditions for preferential treatment as set out in article 52.4 of the UCITS Directive and, provided that the relevant requirements of the 2015 CB Legislation continue to be met for so long as such covered bond is outstanding, article 129 of the Capital Requirements Regulation (CRR).

The 2015 CB Legislation is incorporated in the Dutch Financial Supervision Act (*Wet op het financieel toezicht*) and further laid down in a delegated act and an implementing regulation¹, thereby receiving a firmer statutory basis compared to the Dutch covered bond regulations which were introduced in 2008 (2008 CB Regulations). The aim of the 2015 CB Legislation is to strengthen regulatory supervision on registered covered bonds by the Dutch Central Bank, to increase investor confidence and to lower financing costs of Dutch banks.

The 2015 CB Legislation incorporates new (international) market standards, including the abovementioned EBA best practices, and certain contractual features of existing Dutch covered bond programmes, including mandatory asset cover tests and liquidity buffers.

Although the 2015 CB Legislation contains a number of additional continuing registration requirements focussing on, amongst other things, transparency, cover asset quantity and quality and stress testing, the 2015 CB Legislation

Key issues

Some newly introduced key requirements of the 2015 CB Legislation:

- Article 129 CRR permitted cover assets
- Mandatory asset cover tests, including 5% minimum OC
- Mandatory liquidity buffer
- Mandatory audits
- Mandatory quarterly investor reporting

does not substantially amend the requirements under the 2008 CB Regulations relating to asset segregation, risk management, asset encumbrance safeguards and reporting to the Dutch Central Bank.

Without purporting to be complete, we describe below some newly introduced key requirements of the 2015 CB Legislation which we think are relevant to investors and other market participants.

Transparency on key covered bond conditions

To increase transparency when applying for registration an issuing bank must disclose to the Dutch Central Bank

certain key conditions applicable to the relevant category of registered covered bonds. These conditions include:

- whether the covered bond has one of the following maturity structures: (i) its maturity date cannot be extended (hard bullet maturity) or its maturity date can only be extended for a maximum of 24 months (soft bullet maturity) or (ii) its maturity date can be extended with more than 24 months ((conditional) pass through);
- which type or types of cover assets can unlimitedly be included in the cover pool (primary cover assets) and if more than one type is included, the ratio between them; and
- the jurisdiction in which the debtors of the cover assets are located or resided and the governing law of the cover assets.

Such conditions cannot be changed after the date of application for registration of the relevant category of covered bonds.

An issuing bank has the possibility to combine hard bullet covered bonds and soft bullet covered bonds in one category of registered covered bonds (ie under one issuance programme), provided that the soft bullet covered bonds have a maximum maturity extension of 24 months.

Because of the inclusion of asset quantity and quality requirements in the 2015 CB Legislation (see below), the Dutch legislator did not find it necessary to retain the minimum credit rating requirement applicable to covered bonds registered under the 2008 CB Regulations. A minimum credit rating for registered covered bonds is therefore not required under the 2015 CB Legislation.

Cover assets

Primary cover assets

Currently, under the 2015 CB Legislation the following assets can be used as primary cover assets for the cover pool:

- public sector (guaranteed) exposures as referred to in article 129 CRR, paragraph 1(a) and (b) (excluding credit quality step 2 exposures);
- residential mortgage loans or guaranteed residential loans as referred to in article 129 CRR, paragraph 1(d)(i) and (e) respectively;
- commercial mortgage loans as referred to in article 129 CRR, paragraph 1(f)(i); or
- shipping loans as referred to in article 129 CRR, paragraph 1(g).

An issuing bank may use only one category of cover assets as primary cover assets, save for residential mortgage loans and commercial mortgage loans, which can be combined as primary cover assets, provided that the ratio between these categories is fixed as from the date of registration.

This also means that a covered bond issued by a Dutch bank with corporate or SME loans or RMBS or CMBS used as cover assets would in principle not be eligible for registration pursuant to the 2015 CB Legislation and can therefore not become compliant with the conditions for preferential treatment as set out in article 52.4 of the UCITS Directive.

Substitution assets

The 2015 CB Legislation permits the inclusion of substitution assets in the relevant cover pool provided that the substitution assets do not exceed 20% of the nominal amount of the outstanding registered covered bonds. Substitution assets must either be public sector (guaranteed) exposures as referred to in article 129 CRR, paragraph 1(a) or (b), exposures to institutions as referred to in article 129 CRR, paragraph 1(c) or credit quality step 2 exposures permitted by the Dutch Central Bank as referred to in article 129 CRR, paragraph 1, third sub-paragraph.

In addition to the 20% overall cap on substitution assets, the substitution assets must individually comply with the restrictions applicable to them as set out in article 129 CRR.

Mandatory asset cover tests and overcollateralisation

The 2015 CB Legislation contains two mandatory asset cover tests. Firstly, the total value of the cover assets must be at least 105% of the nominal value of the outstanding covered bonds of the relevant programme. In addition to this minimum overcollateralisation requirement, the total value of the cover assets, so determined in accordance with the restrictions applicable to the relevant type of assets as set out in article 129 CRR, paragraph 1 (for example, a maximum loan-to-value (LTV) ratio of 80% for residential mortgage loans), should at least be equal to the nominal value of the outstanding covered bonds of the relevant programme. With respect to primary cover assets, their nominal value will be taken into account and for substitution assets their market value as determined in accordance with internationally accepted accounting principles.

Defaulted cover assets as referred to in article 178 CRR, cover assets in respect of which third parties are entitled to

(part) of the proceeds thereof (for example, sub-participations), and cover assets which represent exposures to the relevant issuing bank or its group companies must be deducted when determining the value of the cover assets.

Residential and commercial mortgage loans serving as primary cover assets must be re-valued on at least an annual basis or with an increased frequency if required by the Dutch Central Bank. Furthermore, the valuation and other principles as set out in articles 208 and 229 CRR are applicable to the collateral of such cover assets.

Mandatory liquidity buffer

The 2015 CB Legislation requires the cover asset owning entity (ie the covered bond company (CBC)) to have (or generate) sufficient liquid assets to cover in the following six month period the payment by it of interest and principal of the outstanding registered covered bonds, and permitted equal or higher ranking amounts (for example, resulting from obligations arising in a post-issuer default scenario under contracts necessary for or related to the servicing of the cover assets and the payment and administration of covered bonds and cover assets). This mandatory liquidity buffer for principal payments does not apply to soft bullet covered bonds, which have a maturity extension of at least 6 months, or to pass-through covered bonds.

For the purpose of calculating the mandatory liquidity buffer, the CBC may take into account expected cash flows from derivatives and other risk mitigating contracts relating to such payment obligations.

Liquid assets may consist of the same type of assets which are permitted as substitution assets (see above).

Audits

The 2015 CB Legislation requires the appointment of an external accountant which is required to perform at least annually an audit on the cover assets to verify whether the calculations for the abovementioned asset cover tests and mandatory liquidity buffer have been made correctly. The issuing bank must ensure that such audits continue to be performed in the circumstance where such issuing bank is no longer able to service cover assets (ie in a post-issuer default scenario). In addition, the issuing bank must ensure that in a pre-issuer default scenario, the external auditor

shall at least annually perform an audit on a sample of cover assets focussing on the recorded valuation of such cover assets and the administration thereof.

Audit reports must be disclosed to the Dutch Central Bank to enable it to supervise compliance with the 2015 CB Legislation.

Mandatory information undertakings

The transparency for investors in registered covered bonds is provided for by mandatory information undertakings for issuing banks. At least on a quarterly basis an issuing bank must provide information on the cover assets and registered covered bonds under the relevant programme, which information is based on the information required by article 129 CRR, paragraph 7 and the aforementioned EBA best practices. The information must be of sufficient detail to enable investors to adequately analyse the value and coverage of, and risks relating to, their investment.

Sanctions

An issuing bank and the relevant category of covered bonds issued by it will be registered in a register maintained by the Dutch Central Bank if the registration requirements under the 2015 CB Legislation are met. In addition to imposing fines and penalties on the issuing bank, the Dutch Central Bank can cancel the registration of an issuing bank if an issuing bank no longer complies with the relevant provisions of the 2015 CB Legislation, resulting in an issuance stop for the issuing bank. The cancellation of the registration of an issuing bank has no consequences for the registration of registered covered bonds that are outstanding at the time of such cancellation. Therefore, cancellation of registration of the issuing bank should not result in loss of the preferential treatment under article 52.4 UCITS Directive.

The Dutch Central Bank also records in the registry whether the relevant registered covered bonds comply with article 129 CRR. The Dutch Central Bank may cancel such recorded compliance with article 129 CRR, if an issuing bank or the CBC (for example, in a post-issuer default scenario) does not provide the required information to the Dutch Central Bank to monitor compliance with article 129 CRR or if the registered covered bonds no longer comply with article 129 CRR.

Transitional period

Although the 2015 CB Legislation came into force on 1 January 2015, issuers of covered bonds registered under the 2008 CB Regulations prior to 1 January 2015 (or issuers having applied for registration thereunder prior to 1 January 2015), have been given a transitional period of 12 months to comply with the 2015 CB Legislation. It is expected that, to the extent necessary and possible, such issuers will use their annual programme update to implement the 2015 CB Legislation. In any event, such issuers must comply as from 1 January 2016 with the 2015 CB Legislation should they want to maintain the regulatory status of their outstanding covered bonds.

Contacts

Robert Masman

T +31 20 711 9308

robert.masman@cliffordchance.com

Alexander Freund

T +31 20 711 9693

alexander.freund@cliffordchance.com

ⁱ The Prudential Rules Decree to the Financial Supervision Act (*Besluit prudentiële regels Wft*) and the Implementing Regulations to the Financial Supervision Act (*Uitvoeringsregeling Wft*).

This publication does not necessarily deal with every important topic or cover every aspect of the topics with which it deals. It is not designed to provide legal or other advice.

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*Linda Widyati & Partners in association with Clifford Chance.