

Conditional Pass-Through Covered Bonds

Summary

Pass-through covered bonds (PTCBs) can help to reduce liquidity and refinancing risks. They aim at avoiding fire sales of the underlying assets in case of issuer default by transferring the mismatch risk between the maturity of the underlying assets and the maturity of the bonds to the investor, allowing a more orderly sale of the assets. This enables them to achieve wider notching over the issuers' unsecured rating compared to conventional covered bonds resulting in higher and more stable covered bond ratings.

A New Form of Covered Bonds

One of the important features of covered bonds is their dual-recourse character and their bankruptcy remoteness, which means that covered bonds do not automatically accelerate if the issuer becomes insolvent. In case of issuer default, upcoming covered bond redemption and coupon payments are paid out of the cover pool. If the cash flow of the cover pool is not sufficient to cover all upcoming principal and coupon payments, the insolvency administrator will be forced to liquidate some of the cover pool assets.

In the past, the rating agencies assumed that the insolvency administrator could easily monetise the cover assets by bundling them into an asset backed security (ABS), which could then be sold to investors. However, large parts of the securitisation market are still in the doldrums, which means that this exit route is no longer viable. In order to generate cash, the insolvency administrator might be forced to sell the actual cover assets in a short period of time at high discounts to allow timely payments on the covered bonds. The rating agencies require therefore high overcollateralisation levels to cover this fire-sale scenario.

In case of hard-bullet structures, issuers try to tackle this problem by conducting regular pre-maturity tests and by keeping certain liquidity amounts to cover principal and coupon payments on the covered bonds over a certain time period. Soft-bullet structures with extension periods of one year or longer are another way to circumvent the problem. However, whilst the soft-bullet structures lower the refinancing risks, they cannot remove it completely resulting in still high over-collateralisation (OC) requirements from the rating agencies.

We believe these risks are much lower in pass-through structures. Conditional pass-through covered bonds (CPTCBs) are a new form of covered bonds that can help to reduce liquidity and refinancing risks. Currently, various forms of pass-through covered bonds are under discussion, all of them have in common their aim of allowing an orderly sale of the underlying assets in case of issuer default. This is achieved by transferring the mismatch risk between the maturity of the underlying assets and the maturity of the bonds to the investors. The removal of the fire-sale risk enables the CPTCBs to achieve higher ratings than conventional covered bonds and better rating stability as the rating agencies grant them a higher rating uplift over the issuers' unsecured rating.

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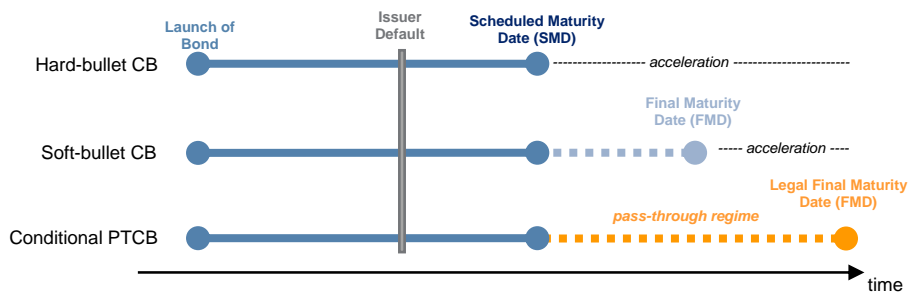
The advantage from the issuer perspective is the lower overcollateralisation requirements by the rating agencies. S&P, for instance, emphasises that in pass-through structures the asset-liability mismatch risk, which typically contributes more than two-thirds to S&P's over-collateralisation requirements, is much lower.

The higher and more stable covered bond ratings make the product more attractive for rating-sensitive investors. Whilst a basic concept in the securitisation industry, the pass-through feature is new for traditional covered bond investors, which means that the investor base for CPTCBs might be slightly smaller than that of more common soft-bullet covered bonds, at least until investors become more comfortable with the product.

In general, there are three major redemption regimes for covered bonds:

- **Hard bullet covered bonds:** The CB survives issuer default, any payments have to be made when due according to the original schedule. Failure to pay on the Standard Maturity Date (SMD) triggers default of the CBs and the CBs accelerate.
- **Soft bullet covered bonds:** The CB survives issuer default, any payments have to be made when due according to the original schedule. Failure to pay on the SMD triggers issuer default, but does not trigger CB default. The extension period grants more time (typically at least 12 months) to repay the CB setting a new Final Maturity Date (FMD). Failure to pay on the FMD triggers default and acceleration of the CB.
- **Conditional pass-through covered bonds (CPTCB):** The CBs survive issuer default, any payments have to be made when due according to the original schedule. Failure to pay at the SMD triggers issuer default, but does not trigger default of that CB. The affected CB turns into pass-through mode. All other outstanding CBs are not affected and would only turn into pass-through mode one after another if they are not redeemed on their respective SMD.

The Redemption Profiles



Source: RBS

De Nederlandsche Bank on PTCB in the Netherlands

The Dutch central bank De Nederlandsche Bank (DNB) has been the first supervisor to comment on conditional pass-through covered bonds. DNB defines a conditional pass-through covered bond as a covered bond with an extension period of more than 24 months. The extension period is the maximum period that the covered bond company may postpone the contractual redemption payment under the covered bonds.

When assessing a covered bond programme, DNB mainly focuses on the risks for the covered bond investors. A very important point for DNB is the transparency in the relevant covered bond documentation about these risks. In DNB's opinion it is therefore necessary to distinguish strictly between conventional covered bonds and conditional pass-through covered bonds, due to the different risk characteristics of these two instruments. In case of the pass-through structure, the mismatch risk between the maturity of the underlying assets and the maturity of the bonds is transferred to the investor. At the same time, a pass-through covered bond has lower market risk compared to regular covered bonds as the structures aim at avoiding fire sales of the underlying assets at any price. This means that the risk of these bonds differs from the risk of regular covered bonds. Both forms of securities may be issued under the supervision of DNB, but not under the same covered bond programme. Issuers may issue under a regulated covered bond programme either exclusively 'regular' covered bonds or exclusively conditional pass-through covered bonds.

This requires clear distinction between regular covered bonds and conditional pass-through covered bonds such that covered bond investors are aware of the risks they take. DNB requires the issuers to provide the following information on a conditional pass-through covered bond in their programme documentation:

- The conditions that (may) lead to activation of the pass-through mechanism and the postponement of the payment (ie, start of the extension period);
- The payments covered by the pass-through mechanism if the extension is activated, ie, does the suspension include only principal redemption payments or any due coupon payments during the suspension as well?
- The rights of the covered bond holders in the case of deferred contractual payments, particularly the (potential) rights to additional interest when the contractual redemption date is deferred.

The Mechanics

NIBC will likely become the first issuer of Dutch Conditional Pass-Through Covered Bonds (CPTCB). We therefore base the descriptions of the mechanics of CPTCB on NIBC's new covered bond programme. Other issuers may deviate from the features of this specific programme, though the basic principle should remain the same. A Conditional Pass-Through Covered Bond is solely the obligation of the issuer and investors are protected by an additional claim against the pool of collateral assets. The Covered Bond Company (CBC) will guarantee the payment of scheduled interest and principal payable. The cash flow of a traditional hard-bullet covered bond and of a CPTCB is identical if the issuer does not default during the life of the bond, ie, coupon and principal payments are identical in size and timing. Two of the main differences of the CPTCB structures (and soft-bullet CBs) compared to hard-bullet covered bond programmes are the *extension period* and the *sale of selected assets*. Main differences of the CPTCB to the hard-bullet and soft-bullet CBs are that ultimately acceleration risks will be replaced by extension risks (while coupons stays constant).

In NIBC's CPTCB Programme, following an issuer event of default, any repayments, including early repayments and excess spread remain with the cover pool until a CB series reaches its Scheduled Maturity Date (SMD). All available cash is used to redeem that series on its SMD. A particular covered bond will only turn into pass-through (1) upon an issuer event of default and (2) when a covered bond reaches its SMD and (3) the available cash combined with the proceeds of a partial sale of the cover pool by the cover pool administrator would not be sufficient to redeem the bond. Other outstanding CBs will not turn into pass-through CBs as long as they are paid as scheduled.

During the process, the Amortisation Test has to be passed. If this test is failed, all CBs turn into pass-through covered bonds. In that case, the CBC will be required to use all funds available to redeem all covered bonds on a pro rata basis. Interest will continue to accrue on the unpaid part of the covered bonds.

An additional new feature in the CPTCB is the minimum documented overcollateralisation (OC). Irrespective of rating agency or CRD requirements this will always entail a minimum OC of 15%.

Extension period

Under the Guarantee, the CBC will be required to redeem each covered bond on the Extended Due for Payment Date that falls 32 years after the maturity date, unless it has funds available or is able to sell cover pool assets to redeem the relevant covered bond on an earlier date. As the cover pool assets have a maximum maturity of 30 years, the Extended Due for Payment Date will therefore always fall after the date on which the latest maturing mortgage loan must be repaid. However, in real life the extension period will likely be substantially shorter due to the accelerating deleveraging of the cover pool making a successful sale increasingly likely over time.

Sale of selected assets

For the CBs in pass-through a portfolio of cover assets is selected randomly, in the same way as for conventional covered bonds. In contrast to conventional covered bonds, the administrator is only forced to sell the assets if the sale proceeds are sufficient to redeem the series without a loss on the bonds. Such sale is also only allowed if the sale and redemption causes no deterioration of the overcollateralization for the remaining outstanding bonds, as to mitigate time subordination of bonds with longer maturities. In case the portfolio is not sold, a new random selection of assets is made to be sold, every six months until the proceeds would be sufficient. In the meantime the cover pool administrator will start deleveraging by passing through principal payments and excess spread on a monthly basis making a successful sale increasingly likely to occur.

The conditional PTCB mechanism only results in a difference compared to a soft-bullet CB in the case where a sale of assets without a loss on the bonds would not be possible. In this situation the soft-bullet CB would experience a loss on the bonds while the conditional PTCB would pass through any available proceeds and attempt to sell the pool again in six months.

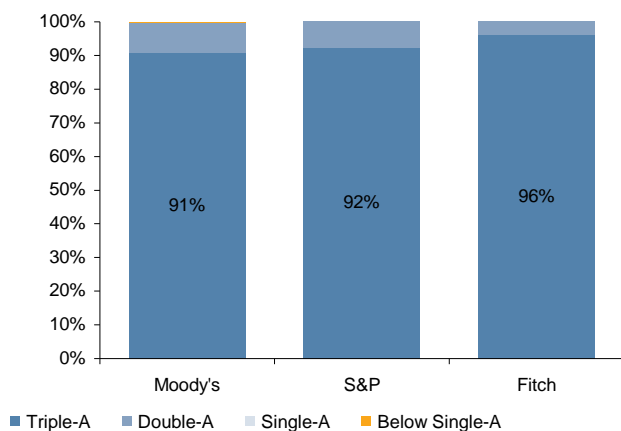
With the pass-through principal payments and excess spread the pool deleverages which allows for a sale at a steeper discount without facing a loss on the bonds. The term of any extension period is therefore expected to be limited.

The Rating Agencies' View

Moving away from a pure triple-A covered bond market

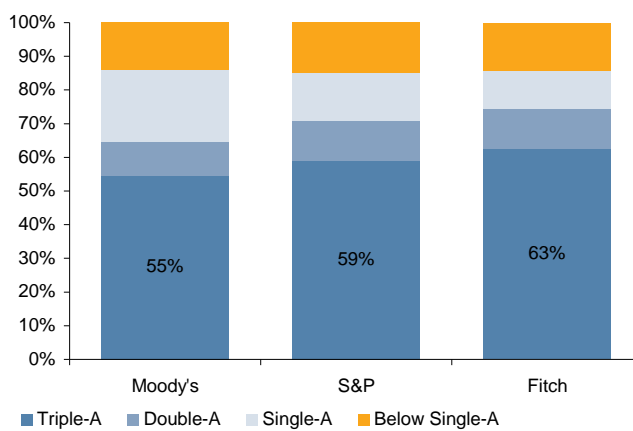
Traditionally, covered bonds have been a triple-A product. As the left-hand chart below shows, at the end of June 2010 more than 90% of the rated covered bonds had a triple-A rating, with the remainder being in the double-A bracket. However, over the last three years, the asset class has moved away from being a genuine triple-A market segment. The share of benchmark jumbo covered bonds that do not have Moody's highest rating increased from a mere 9% at the end of June 2010 to about 45% in September 2013. In the case of Fitch, the non-AAA ratio has increased from only 4% in June 2010 to 37% in September 2013. S&P lies between Moody's and Fitch with about 40% of the rated covered bonds not having a triple-A rating. Main drivers of the negative rating trend were sovereign and issuer downgrades – particularly in (but not limited to) Europe's periphery – but also higher requirements from rating agencies.

Rating Overview June 2010
(volume-weighted; excluding non-rated bonds)



Source: RBS, Bloomberg

Rating Overview Sep 2013
(volume-weighted; excluding non-rated bonds)



Source: RBS, Bloomberg

CPTCBs try to reduce the rating volatility by reducing the asset-liability mismatches (ALMM) risk in case of issuer default, which results in higher and more stable covered bond ratings. The three major rating agencies have different approaches for rating conditional pass-through structures ranging from S&P allowing a de-linked approach to Moody's, which maintains the strongest link to the issuer rating:

- **S&P:** In June 2013, S&P said pass-through structures can help reduce risks, thereby adding to the stability of [its] covered bond ratings¹. They reduce in particular the asset-liability mismatch risk, which typically contributes more than two-thirds to S&P's

¹ Source: "The Gradual Convergence Of Covered Bonds With ABS Might Bring Additional Benefits", S&P June 2013.

overcollateralisation requirements. Its covered bond methodology allows the agency to rate a CB programme with no asset-liability mismatches (ALMM) risk on a de-linked basis from the issuer. This matching of assets to liabilities may be the result of structural measures, such as the issuance of pass-through covered bonds, or a contractual commitment by the issuer to maintain levels of credit enhancement such that asset cash flows are always adequate to pay maturing covered bonds.

- **Moody's:** In theory, it is possible for a programme to increase its de-linkage over and above that suggested by the TPI matrix, or even for it to be fully de-linked from the issuer's rating so that the covered bond rating can theoretically always remain at the maximum rating level achievable in the relevant jurisdiction. However, to date, Moody's has not considered the timely payment analysis for any programme as strong enough to achieve full de-linkage.
- **Fitch:** Pass-through covered bonds with three months' coverage of interest and expenses can achieve a D-Cap of 8 ('minimal discontinuity risk') if the other risk components (asset segregation, liquidity gap and systemic risk, alternative management and privileged derivatives) do not negatively impact the overall assessment of the programme. This means that the minimum Issuer Default Rating (IDR) to achieve a AAA covered bond rating is BB+, assuming a 2-notch uplift for recoveries. This is because there should be no need to liquidate cover assets, which removes the majority of payment interruption risk for covered bonds after an issuer default and leads to a discontinuity risk profile that is more in line with amortising Structured Finance (SF) transactions. The reason that a D-Cap still applies – in contrast to SF transactions – is because "covered bonds allow for significantly more flexibility regarding cover pool composition and issuance capacity than typical SF transactions"². Fitch sets the legal final maturity date of pass-through covered bonds by reference to the longest dated asset in the cover pool.

In the case of NIBC's Conditional Pass-Through CB programme, both S&P and Fitch have assigned AAA ratings. S&P highlights the mitigation of the asset and liability mismatch risk and Fitch assigned a D-Cap of 8 which is driven by the 'minimal discontinuity' assessment of the 'liquidity gap and systemic risk' component which is not compromised by any of the other D-Cap components.

ECB Repo Eligibility

We would expect that the conditional PTCB are ECB repo eligible as long as the covered bonds are compliant with UCITS and CRD as there are no further requirements or limitations with regards to maturity extensions of covered bonds.

Potential Issuers and Past Experience

Until recently, banks have mostly used pass-through covered bonds for sale and repurchase transactions with central banks. S&P in a recent note stated that it believes that the issuance of pass-through covered bonds, and their acceptance by investors, will increase. The agency expects that these instruments will be used for novel asset types or emerging countries, but that they will also become a feature in traditional covered bonds.

In the past, we have seen covered bonds in the UK with ultra-long extension periods, when in particular, smaller building societies used these instruments to achieve triple-A ratings allowing them to repo these bonds with the Bank of England under the Special Liquidity Scheme (SLS).

² Source: Covered Bonds Rating Criteria, Fitch Sep 2012.

Over the last few years, many covered bond issuers out of Greece, Cyprus, and Italy introduced new, separate CB programmes with (ultra-) long extension periods thereby ensuring covered bond ratings that allow them to access to central bank repo and overnight facilities.

Moreover, nor is Commerzbank's SME covered bond a hard bullet as the structure allows the cover pool administrator to revert to pass-through if the sellable value of the assets is too low to pay back investors.

NIBC announced in July that it plans to issue a CPTCB. Its new covered bond programme is the first Dutch conditional pass-through covered bond programme. The issuer has applied for registration of the programme with the DNB in accordance with the Dutch covered bond regulations. As part of the registration process the issuer also aims for UCITS and CRD compliancy of the bonds.

Investor Demand

Conditional pass-through covered bonds are a new instrument and their success and ability to establish a new market segment will depend highly on investor demand. We expect that conditional pass-through covered bonds will be particularly attractive for certain investor types. Investors who bought securitisation instruments in the past are used to such structures and probably appreciate the additional claim against the issuer. Moreover, as these instruments should achieve higher ratings compared to regular covered bonds with higher rating stability, rating sensitive investors (who at the same time do not mind an elevated extension risk) might be attracted to these bonds.

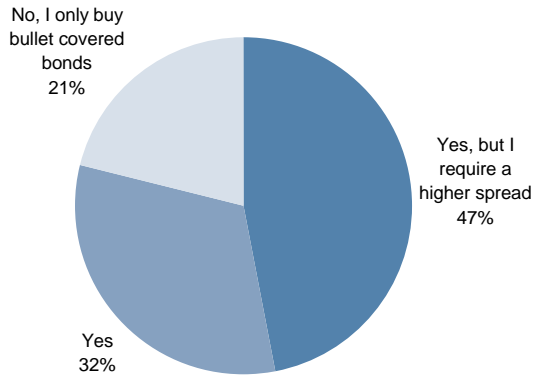
At the same time, CPTCB should also be interesting for ordinary covered bond investors, particularly if the issuers offer a spread pick-up for the additional risk. Based on the default statistics of the three major agencies, a double-A rated bank has an average 5-year probability of default (PD) of 0.16% and a single-A rated bank of 0.84%. Even the PD of a triple-B rated issuer is just 2.27%. In case of a single-A rated issuer, this means that there is 99% likelihood that the repayment profile of a 5-year conventional CB and that of a CPTCB will be the same. Only in less than 1% of the cases will the two cash flows be different as the CPTCB would switch to pass-through in case of issuer default (and even then only if the administrator is not able to sell assets at the required price). It is important to note that 'different' here does not necessarily mean lower – there are scenarios where the repayment profile of a pass-through covered bond is expected to be higher than that of a hard-bullet or soft-bullet covered bond.

In December 2012, Fitch conducted its third annual Covered Bonds Investor Survey³. Whilst probably not representative for the entire covered bond investor universe, it provides some insight into how parts of the covered bond investor community view certain aspects of the covered bond market. The survey shows that a growing number of investors – 79% compared to 71% in 2011 and 62% in 2010 – are prepared to buy covered bonds with soft-bullet maturities. The percentage of participants that would only buy hard-bullet covered bonds has decreased to 21%, from 29% and 34% in 2011 and 2010, respectively. The response to pass-through covered bonds, however, was unchanged, with a total of 47% of respondents stating they would buy them. We expect that this number will markedly increase as soon as investors get more comfortable with the structure and understand the details and advantages of conditional pass-through covered bonds in terms of higher rating stability and higher recovery values in case of issuer default. Only 29% stated that they would only buy hard bullet-covered bonds,

³ 97 investors responded to the survey, of which 10% have more than €20bn of covered bonds under management, 30% have between €5bn and €20bn, and 61% have less than €5bn in their portfolios. All but three are based in EMEA.

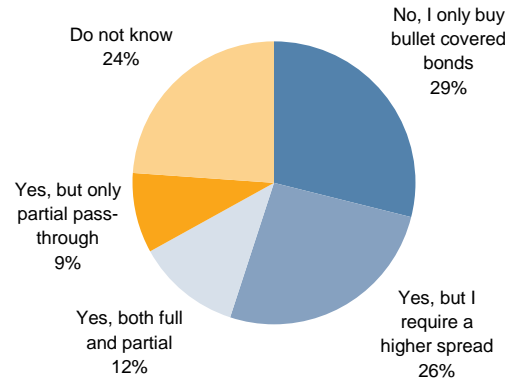
whilst almost a quarter 'do not know' if they would buy pass-through covered bonds. The change over the last few years in the investor perception of soft-bullet covered bonds and the high share of undecided investors makes it likely, in our view, that investor acceptance for conditional pass-through covered bonds will rise further.

Would You Buy Soft-Bullet Covered Bonds?⁴



Source: Fitch, RBS

Would You buy Pass-Through Covered Bonds?⁵



Source: Fitch, RBS

Conclusion

Conditional pass-through covered bonds are an interesting addition to the existing spectrum of covered bond structures. Pass-through covered bonds (PTCBs) can help to reduce liquidity and refinancing risks. They aim at avoiding fire sales of the underlying assets in case of issuer default by transferring the mismatch risk between the maturity of the underlying assets and the maturity of the bonds to the investor and by allowing a more orderly sale of the assets. This enables them to achieve wider notching over the issuers' unsecured ratings compared to conventional covered bonds, resulting in higher and more stable covered bond ratings.

Though a basic concept in the securitisation industry, it is new for traditional covered bond investors. We agree with De Nederlandsche Bank (DNB) that transparency is key as the risks of pass-through covered bonds differ in case of issuer insolvency from the risk of conventional covered bonds. Transparency also helps to make covered bond investors more comfortable with this new product. At the same time, investors should also bear in mind that in case of a single-A rated issuer, only in less than 1% of the cases⁶ will the cash flows of a CPTCB differ from that of a hard-bullet covered bond, as the CPTCB would switch to pass-through. Importantly, 'different' does not necessarily mean lower. S&P believes that CPTCBs will likely minimise losses in case of an issuer default, allowing investors to maximise recoveries in a worst-case scenario. In all other cases the repayment profile will be the same. It will be interesting to see how investors value the differences in the repayment profile in case of issuer default of conditional pass-through, hard-bullet and soft-bullet covered bonds.

⁴ Fitch Survey Question was "Issuers have various ways to address liquidity gap risk. One way is to issue covered bonds with an extendable maturity (soft bullet). Would you buy soft bullet covered bonds?"

⁵ Fitch Survey Question was "Another way to mitigate the liquidity gaps is to issue covered bonds with a pass-through redemption profile, either at the inception (full pass-through) or upon an issuer default (partial pass-through). Would you buy pass-through covered bonds?"

⁶ Based on the average 5-year Probability of Default (PD) ratios of the three major rating agencies.

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