

ASSET MANAGEMENT AND INVESTORS COUNCIL

COVERED BOND INVESTOR COUNCIL

Cola Working Group (CWG): Comments and findings on NIBC conditional pass-through

The comments and findings stated below are based upon publicly available information, represent the views of various investors and are not intended to be and not to be relied upon as trading recommendations of any kind. The views contained herein are subject to change without further notice.

1. The CWG is unanimously of the opinion that the new product by NIBC is a Covered Bond. It is issued by a licensed bank, is governed by Dutch Covered Bond legislation, supervised by the Dutch Central Bank, and uses the same collateral as in existing standard Covered Bond programmes. The bonds are compliant with UCITS and CRD IV.
2. There is a consensus but no unanimous vote in the CWG to include NIBC conditional pass-through in the relevant Covered Bond indices. The bonds are hard bullet obligations of the issuer but may turn into a conditional as well as a full pass through structure after the default of the issuer. If the bonds were to switch into pass through, the repayment of the bonds may deviate significantly from the originally scheduled payment date. This is creating difficulties for some mandates for example with either fixed maturity funds or for mandates with a maximum maturity limit shorter than the legal maturity of the conditional pass through program. Additionally, investors buying such a product on an asset swap basis will find it difficult to manage the position once the hard bullet obligations turns into a pass through structure after the default of the issuer. Our understanding is that once a Covered Bond starts amortizing on a pass-through basis, it will probably not stay in the relevant bond indices any further - as these are made up of fixed rate bullet bonds, - even though payments may still be made to investors on the basis of the originally agreed coupon.
3. Investing in the NIBC bonds involves an increased degree of uncertainty about the timing of the principal repayment after the default of the issuer not only due to a possible extension as stated under point 2 but the principal may also be repaid significantly before original maturity date due to the random asset selection process embedded in the program after if the amortization test has been breached. This mechanism might lead to a sale of the whole cover pool for the sake of repaying all outstanding Covered Bonds at the same time, in case the timely sale of the whole

cover pool creates sufficient proceeds (in a full pass-through scenario). This is different from hard bullet programmes following the default of the issuer.

A hard bullet structure is of course also subject to early repayment risk. In the NIBC structure – once the programme has shifted from conditional to full pass-through, after having breached the 15% OC - the investor might be repaid early even without having had an CBC event of default if the assets are performing relatively well and overcollateralization is still intact but just below the required level. Within a hard bullet structure, following the issuer insolvency early repayment occurs if the assets' quality deteriorates, leading to an event of default and having rating implications because the coverage of outstanding bonds has become insufficient. Within the full pass-through scenario proceeds from the obligation to sell the whole pool may be sufficient to repay all outstanding bonds ahead of schedule but without necessarily having a negative rating impact. Indeed the fully delinked rating approach states de facto that a bond may remain well in the investment grade post issuer insolvency but still does not pay according to original bond schedule but possibly ahead of schedule.

The cash flow characteristics summarised under points 2 and 3 above cause some concerns and possibly asymmetries, when a conditional pass through / pass through is included in the current investment universe defined by the relevant Covered Bond indices. Accordingly, occasions may occur where mandates in need of a fixed cash flow structure or with restrictions regarding the maximum allowed maturity of individual bonds in a portfolio refrain from buying these structures in order to fully comply with their guidelines also in a strict interpretation, i.e. despite the fact that the bonds are hard bullet maturities as long as the issuer is solvent. If conditional pass through / pass through were to gain further weight in the relevant indices, this could create a relevant deviation between the investible universe of bonds and the benchmark the portfolio is measured against.

4. In a conditional pass through structure, the usual and almost natural mismatch between underlying assets and outstanding bonds which creates amongst other things the liquidity risk in a post insolvency scenario for hard bullet covered bond programmes is mitigated by the more flexible repayment schedule as described above. Accordingly, NIBC is not using derivatives like e.g. interest rates swaps to mitigate ALM risks. To that extend, no counterparty risk occurs.
5. From an economic point of view, the CWG does not see a material difference between an ultra-long soft bullet structure (e.g. 25 years) and a conditional pass-through one. This statement needs to be seen in the light of net asset value perspective (NAV). It has to be noted however that in case of NIBC, there is an obligation for the cover pool administrator in the full pass-through scenario to constantly (every 6 months) check, whether a sale of the cover assets is sufficient to repay outstanding bonds which might lead to in turn to different cash flow structures. The sale of assets is also mandatory.
6. In the view of the CWG, the emergence of NIBC has again brought light to a weakness in the rating agencies methodology from the investor's perspective – for good or for bad: the

definition of a default. While the rating agencies at least in economic terms generally address possible delays in the contractually agreed payment schedule, this view does not take into consideration mark-to-market volatility and/or net present value calculations. So obviously timing does make a difference for investors, as getting back the principal in a pass through scenario (which might be just after 30 years or so) might be worse than a separate insolvency of the cover pool when calculating for net present values for both alternatives. Several sell side analysts pointed out that extension risk (as well as the early repayment risk in point 3 above) is not included in a credit rating from rating agencies. In the view of the majority of the CWG, a default is clearly a failure to redeem at a scheduled maturity instead of not fully redeeming the bond at the legal maturity date. The structure thus places emphasis on the protection of the principal repayment, and not necessarily on the net asset value (NAV) of the investment. In the light of accounting standards, the appeal of this mechanism will be viewed differently by the various types of investors. Compared to other existing NIBC Covered Bond programme, the OC within the conditional pass-through has been lifted to 15% minimum. It has to be noted that a mere 15% minimum OC under the old hard bullet programme would have not been deemed sufficient by the rating agencies to achieve the rating level currently attached to this conditional pass-through version. Given the rating agencies' approach towards delinkage in the conditional pass-through structure, it is expected that the rating volatility of this programme will be lower compared to that of a traditional hard bullet programme. However this statement should be reviewed following the publication of announced changes in rating agencies methodologies.

7. Despite using Dutch residential mortgages with a maximum maturity limit of 30 years, there are no limitations to the issuer with regard to the amortization structure (or any kind of minimum amortization) being used for the Covered Bond issuance either with reference to the Dutch Covered Bond legislation or the prospectus itself at least to our understanding, so the pool could potentially develop over time into a pool with very long running interest only mortgages. Accordingly, the extension risk is relevant to investors as the composition of cover pool assets is allowed to vary over time.
8. Given the concerns raised by some investors with regard to the inclusion of conditional pass through Covered Bonds in the relevant indices, the CWG would also to explore the effects of pure pass through structures being included in the relevant indices. Without an in-depth discussion and just as a point for future discussions, the question also emerged whether for the sake of transparency covered bond programs with non-standard cash flow procedures post insolvency (i.e. redemption of outstanding bonds possible either before or after originally agreed schedule) could be labeled with the rating suffix "sf" for structured finance. We are not aware of a full pass-through Covered Bond program as of today but would question very much the inclusion of such a program in the relevant bond indices as index providers regularly opt for bullet maturities.

