

Timely Payment in Issuer's Insolvency

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TITLE CHAPTER

- Lessons from the Crisis
- Where do Mismatches come from?
- Timely payment – a 3D Problem
- Timely payment embedded in Cover Pool ALM
- What doesn't fit will be made to fit.
- Range of Actions to assure Timely Payment
- Passing on the Risk – Soft Bullet
- Discussing Covered Bond Models

Lessons from the Crisi(e)s: Errare Humanum Est

- The sovereign is lender of last resort and acts in a stabilizing way
 - ... see European peripheral countries

- The issuer credit quality safeguards a minimum degree of stability
 - ... see Depfa/Hypo Real Estate, Dexia, Düsseldorf Hyp

- Jumbo Covered Bonds are a liquid asset class
 - Lesson I – Taught in 2H 2007 und 1Q 2008

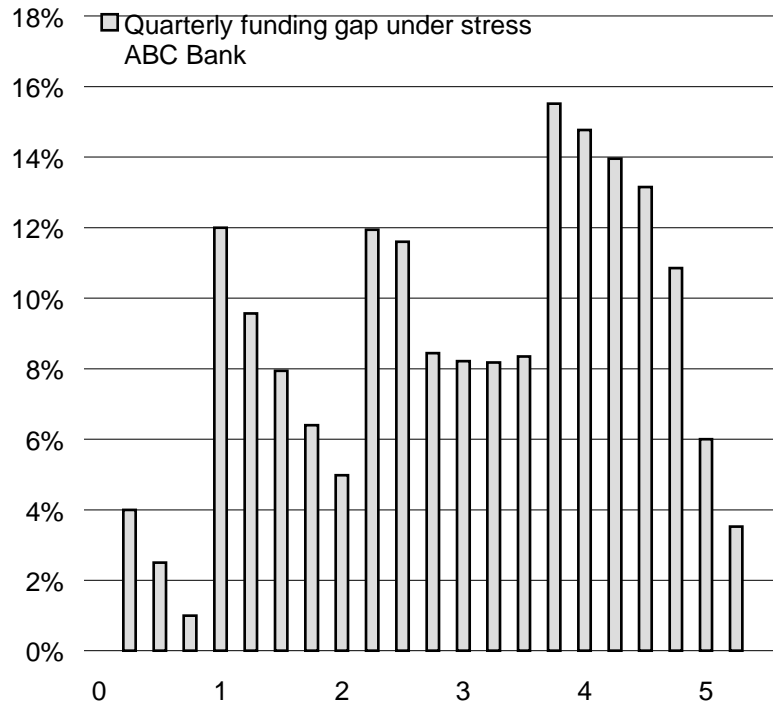
- Sovereign debt and SSAs are liquid
 - lesson taught for the first time in Austria and France etc. in 1Q 2009. Now a permanent situation in large parts of Europe

- Access to Interbank Funding is granted and only a question of price
 - ... see Depfa, Düsseldorf Hyp, Hypothekenbank in Essen in the Lehman aftermath; see current situation

- **Liquidity gaps in cover pool ALM are not a major concern at least within certain limits**
 - **Consequential error from "Sovereign debt and SSAs are liquid" and "Access to Interbank Funding is granted and only a question of price"**

Where do Liquidity Gaps come from?

Liquidity gaps in the cover pool ALM of ABC Bank



Source: Moody's

Mismatches in the Cover Pool ALM caused by:

- Different formats of cash flows (amortizing cover assets vs. bullet bonds)
- "atomistic" collateral vs. large-sized funding
- Gaps caused by
 - different final maturities and/or refinance periods
 - Special structures like Index-linked etc.
 - Call rights
 - etc...

Timely payment – a 3D Problem

- **First Dimension:**

Timely payment with regards to interest payments

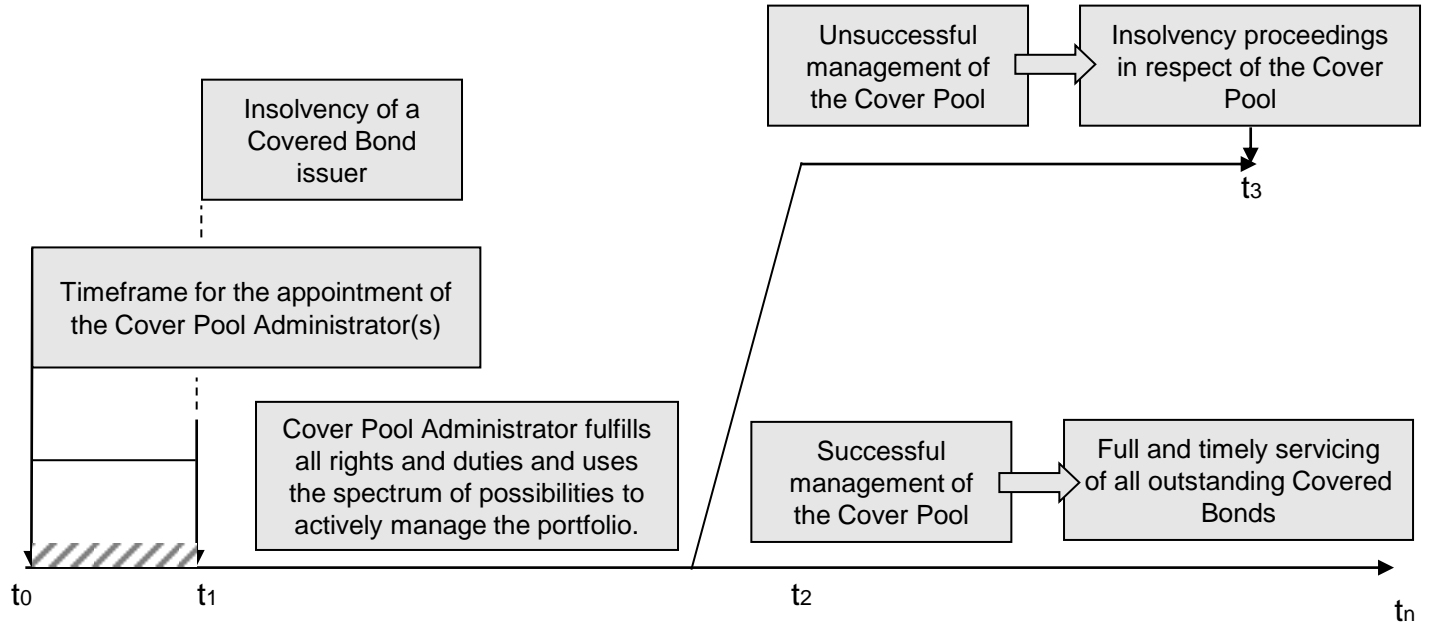
- **Second Dimension:**

Timely payment with regards to principal payments

- **Third Dimension:**

Timely payment with regards to payments from derivative contracts

Management of timely payment in an ideal case



Toolbox of the administrator: "What doesn't fit will be made to fit."

- The cover pool administrator might have one or more of the following "tools" in his toolbox:
 - Drawing on liquidity facilities that have been provided ex ante
 - Selling the cover pool operation of parts of it – with particular respect of substitute collateral
 - Issuance of new debt in direct way, in collateralized or securitized form
 - Issuance of new debt in an indirect way
 - Generating liquidity by way of repo transaction both with the ECB or with third parties.

- All of the above measures ex ante have a negative effect on the issuer.

- In the past few years, in particular since the introduction of structured covered bonds but also due to pressure of rating agencies, the toolbox has been amended by a whole new layer: soft bullet redemptions. A whole new layer since the problem of timely payment has been "solved" by the re-definition of what is considered timely.

- under certain circumstances, issuers or cover pool administrators are entitled to defer the redemption payment for a pre-defined period at a pre-defined interest rate.

Range of Actions of a Cover Pool Administrator in the practical example of the Pfandbrief

■ *Rights ...*

- The cover pool administrator is entitled **carry out legal transactions** in respect of the cover pools insofar as this is necessary for an orderly settlement of the cover pools in the interest of the full satisfaction of the Covered Bond creditors. In particular he can **raise liquidity in order to safeguard the timeliness of payments**
- The cover pool administrator is entitled to **collect the claims according to their contractual maturity and to foreclose** should a foreclosure process be necessary.
- In fulfilling his duties, the Cover Pool Administrator has the **right to access the human and technical infrastructure of the Covered Bond issuer**. The compensation for this is entirely real-cost-based.
- The Cover Pool Administrator is allowed to **collect and use personal data** inasmuch as it is necessary to fulfill his duties.
- The cover pool administrator shall be entitled to **receive remuneration for his work** and a **refund of appropriate expenses**. The costs of the management by the cover pool administrator including his remuneration and refund of his expenses shall be borne proportionally out of the assets recorded in the cover registers.

■ *... and Duties*

- He **represents the Covered Bond bank in and out of court**. Representing the bank and acting in the name of the bank is the entry ticket for the repo business with the ECB.
 - The cover pool administrator shall manage the assets with the **due care of an orderly and conscientious manager**. If he violates his duties he shall be liable to pay damages to the Covered Bond bank.
 - Upon request of the court to **report the current situation** and the management.
 - The cover pool administrator and the insolvency administrator shall **notify each other of any information which might be of importance** for the insolvency proceedings of the Covered Bond issuer or the management of the cover assets.
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The Plan B: Different Redemption Formats

Hard vs. Soft Bullets

- Soft bullet redemptions have become increasingly popular from issuer side since it massively facilitates liquidity management in the cover pool.
 - With regards to rating the consequence of the facilitated liquidity management is either easier access to Aaa/AAA (larger possible upnotch) or a more stable Aaa/AAA rating for covered bonds.
 - The soft bullet provisions allow for postponing the redemption of a bond for a period usually between 12 months and 15 months. Multi-Cédulas come usually come with a 2Y soft bullet. Some retained transactions in UK even bear a 99Y soft bullet in order to practically guarantee Aaa/AAA ratings in order to qualify for drawing on emergency lines with the BoE.
 - During the extension period the bonds pay either 3m or 6m Euribor plus the original reoffer spread.
 - In the recent months soft bullet covered bonds have come under general suspicion to fall victim to an opportunistic abuse as an extension option. In order to assess this possibility it is necessary to take a look at the extension wording which is to be found in the bond documentation.
 - The key question is who is empowered to make use of the extension wording: the issuer or the cover pool administrator. Linked to this condition is the question whether a sole failure to pay from the side of the issuer is sufficient for the extension or whether it is the combination of an issuer failure to pay plus a failure to pay from the side of the cover pool.
 - In the former case, when the issuer failure to pay is sufficient, one might argue that this might be a basis for opportunistic behavior to abuse the extension as an option. The issuer might then – in order to prevent a default and a segregation event – extend the bonds without further consequences. In the latter case a segregation event has to be triggered in order to qualify for this decision making which per se excludes opportunistic abuse.
- Issuers using soft bullet issues are all Canadian, Danish, Greek, Italian (exception old CDEP), Norwegian, UK (with exception of older BACR) and US.
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Soft Bullet – A short look at the details

■ Issuer has the decision power

*If an Extended Final Maturity Date is specified as applicable in the Final Terms for a Series of Ordinary Notes and the **Issuer has failed to pay the Final Redemption Amount** on the Maturity Date specified in the Final Terms, then (subject as provided below) **payment of the unpaid amount by the Issuer shall be deferred** until the Extended Final Maturity Date, provided that any amount representing the Final Redemption Amount due and remaining unpaid on the Maturity Date may be paid by the Issuer on any Interest Payment Date occurring thereafter up to (and including) the relevant Extended Final Maturity Date.*

- To be found in Norway, Finland, Denmark, Ireland, Portugal

■ Cover pool administrator has decision power

*If the Issuer fails to pay the Final Redemption Amount of the relevant Series of Covered Bonds on the relevant Maturity Date (subject to applicable grace periods) **and if the Guaranteed Amounts equal to the Final Redemption Amount of the relevant Series of Covered Bonds are not paid in full by the Guarantor** on or before the Extension Determination Date (for example, because following the service of an Issuer Default Notice on the Issuer and the Guarantor, the Guarantor has or will have insufficient moneys available in accordance with the Guarantee Priority of Payments to pay in full the Guaranteed Amounts corresponding to the Final Redemption Amount of the relevant Series of Covered Bonds), then **payment of the unpaid amount pursuant to the Covered Bond Guarantee shall be automatically deferred** and shall become due and payable one year later, on the Extended Maturity Date (subject to any applicable grace period).*

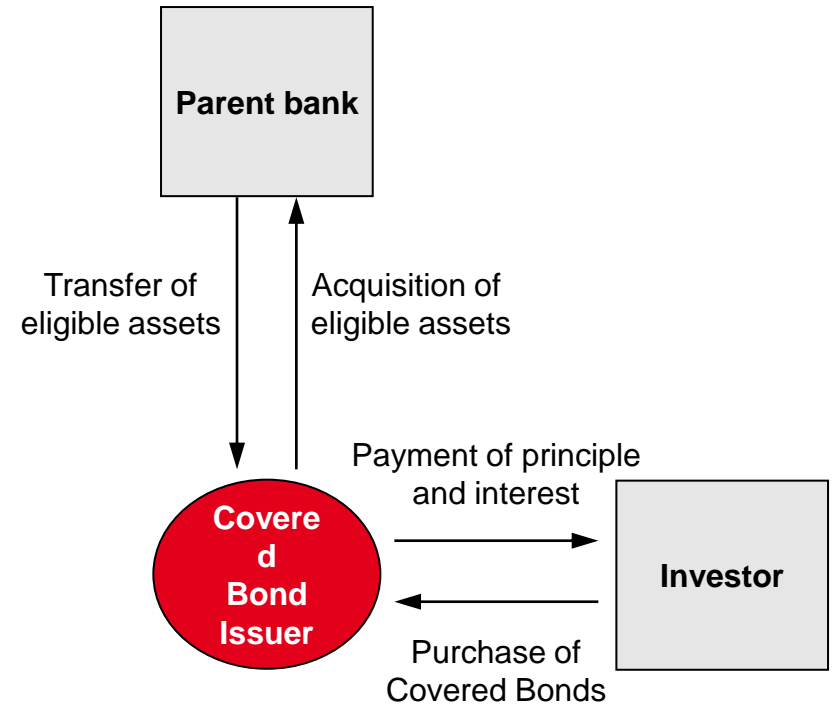
- To be found in Italy, UK, Greece, Netherlands
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Practical Considerations (I)

Model 1

Covered Bond issuer is completely specialized funding institute: France, Ireland, Norway

- Origination and servicing of eligible assets and management of Covered Bond issuing institute by parent bank or other parent institution
- Funding institute has no other function than holding (or mainly holds) eligible assets
- Issuer has the legal status of a credit institution
- Issuance governed by special legal framework
- Issuer has no or almost no staff
- Decisive = insolvency segregation of CB issuer from parent bank
- CB issuer capable of acting in spite of insolvency of parent bank?

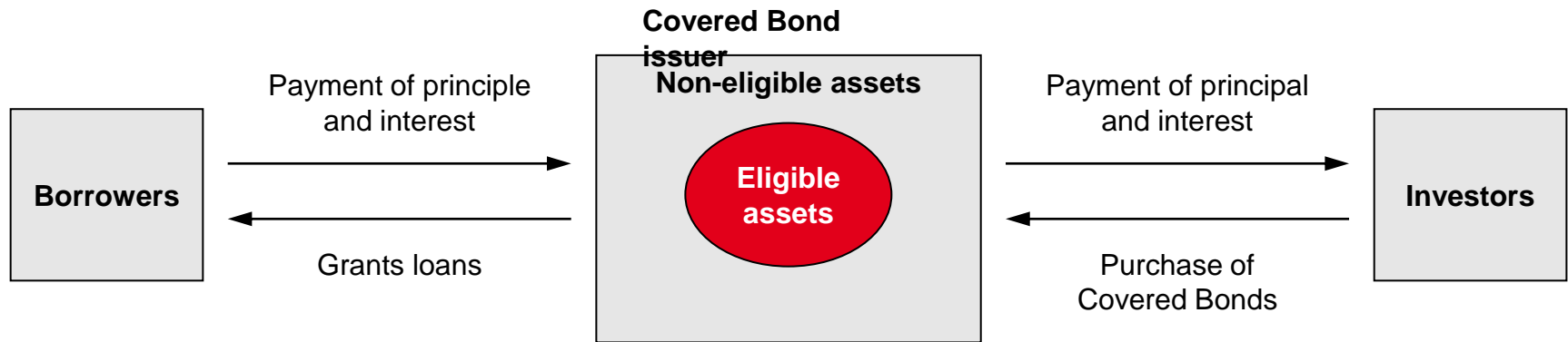


Practical Considerations (II)

Model 2

Covered Bond issuer is specialized credit institution by law: Denmark, Hungary, Luxemburg, Poland

- Issuer originates, services and funds eligible and non-eligible business
- Loan origination restricted by law to mortgages and public-sector loans
- Issuer has the legal status of a credit institution
- Issuance governed by special legal framework
- Decisive = insolvency segregation of cover assets from insolvency estate



Practical Considerations (III)

Model 3

Covered Bond issuer is universal credit institution:

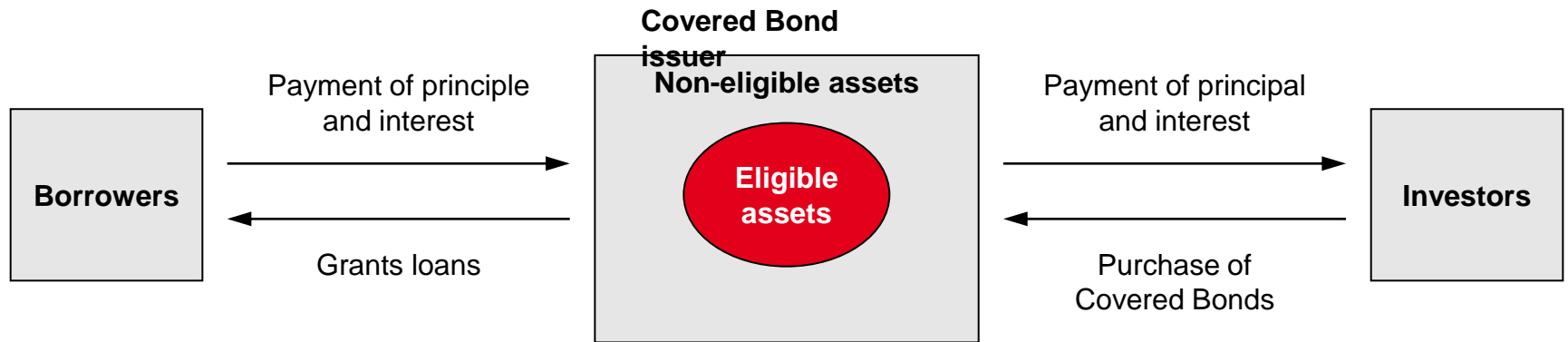
- Issuer originates, services and funds eligible and non-eligible business
- Strict eligibility criteria apply to eligible cover assets
- Issuance governed by special legal framework
- Decisive = insolvency segregation of cover assets from insolvency estate

With qualified Covered Bond license

Austria, Finland, Germany, Iceland, Latvia, Slovenia, Sweden

Without qualified license

Bulgaria, Czech Republic, Greece, Lithuania, Portugal, Spain, Slovakia

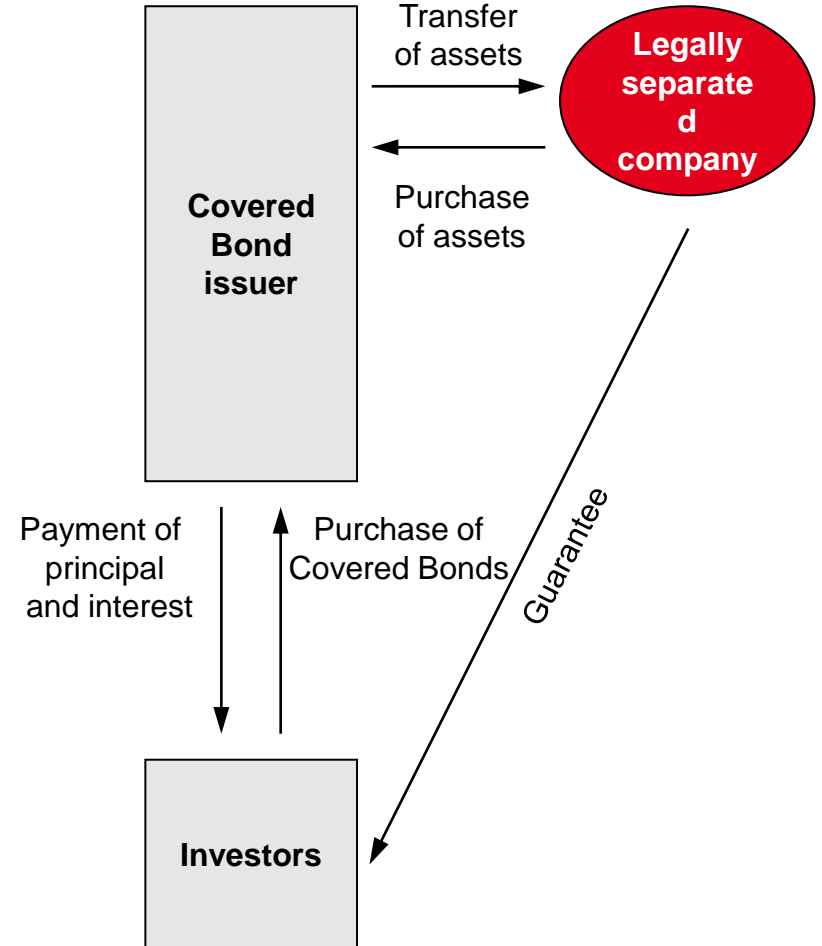


Practical Considerations (IV)

Model 4

Covered Bond issuer is using SPV to achieve insolvency segregation of cover assets: Italy, Netherlands, UK

- Covered Bond issuer (credit institution) originates, services and funds eligible & non-eligible loans
- Transfer of assets onto legally separated entity (SPV without the legal status of a credit institution)
- Legally separated entity guarantees payment of principal and interest
- If insolvency segregation not governed by special legal framework but based on general law
 - Special public supervision covering legal structure ?
 - Legal structure disclosed in detail to public?



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