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*About the Authors*

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## Summary of Contents

<b>About the Authors</b>	<b>v</b>
<b>List of Abbreviations</b>	<b>xxxi</b>
<b>English-Dutch List of Legislation</b>	<b>xxxiii</b>
<b>Preface</b>	<b>xxxvii</b>
<b>Chapter 1</b>	
<b>Introduction to Financial Law in the Netherlands</b>	<b>1</b>
<i>M.S. Lotay &amp; M.C.A. van den Nieuwenhuijzen</i>	
<b>Chapter 2</b>	
<b>Types of Securities and the Statutory Framework Applicable to Securities</b>	<b>19</b>
<i>L.J. Silverentand</i>	
<b>Chapter 3</b>	
<b>Primary and Secondary Offerings of Securities</b>	<b>47</b>
<i>H.B.W. Beerlage &amp; J.H. Horsmeier</i>	
<b>Chapter 4</b>	
<b>The Regulation of Investment Firms in the Netherlands</b>	<b>73</b>
<i>W.J. Horsten</i>	
<b>Chapter 5</b>	
<b>Clearing and Settlement in the Netherlands</b>	<b>99</b>
<i>B.J.A. Zebregs</i>	

*Summary of Contents*

<b>Chapter 6</b> <b>Custody of Securities and Book-Entry Transfer of Rights Regarding Securities</b>	<b>135</b>
<i>B.F.L.M. Schim</i>	
<b>Chapter 7</b> <b>Listing and Delisting</b>	<b>171</b>
<i>T.M. Stevens</i>	
<b>Chapter 8</b> <b>Takeover Bids and Anti-takeover Devices in the Netherlands</b>	<b>195</b>
<i>M.J.G.C. Raaijmakers &amp; P.A. van der Schee</i>	
<b>Chapter 9</b> <b>Investment Funds</b>	<b>217</b>
<i>M.C.A. van den Nieuwenhuijzen</i>	
<b>Chapter 10</b> <b>Derivatives</b>	<b>239</b>
<i>M.S. Lotay</i>	
<b>Chapter 11</b> <b>Repos and Securities Lending</b>	<b>303</b>
<i>W.A.K. Rank</i>	
<b>Chapter 12</b> <b>Securitisation</b>	<b>335</b>
<i>R.E.G. Masman &amp; P.N.J. van Welzen</i>	
<b>Chapter 13</b> <b>Covered Bonds</b>	<b>387</b>
<i>R.A. Stegeman &amp; J.C. Westermann</i>	
<b>Chapter 14</b> <b>Caretaking Duties and Investment Firms</b>	<b>411</b>
<i>S.B. van Baalen</i>	
<b>Chapter 15</b> <b>Prospectus Liability in the Netherlands: Consequences of the Unfair Commercial Practice Rules (Wet Oneerlijke Handelspraktijken, Wet OHP)</b>	<b>443</b>
<i>T.M.C. Arons &amp; A.C.W. Pijls</i>	
<b>Chapter 16</b> <b>Litigation and Securities Law</b>	<b>487</b>
<i>G.P. Roth &amp; M. van Eersel</i>	
<b>Index</b>	<b>523</b>

# Table of Contents

<b>About the Authors</b>	<b>v</b>
<b>List of Abbreviations</b>	<b>xxxi</b>
<b>English-Dutch List of Legislation</b>	<b>xxxiii</b>
<b>Preface</b>	<b>xxxvii</b>
<b>Chapter 1</b>	
<b>Introduction to Financial Law in the Netherlands</b>	<b>1</b>
<i>M.S. Lotay &amp; M.C.A. van den Nieuwenhuijzen</i>	
1.1. Introduction to the Book	1
1.2. Summary of the Book	2
1.3. Introduction to Banking	6
1.3.1. Introduction	6
1.3.1.1. What Is a Loan Agreement?	6
1.3.1.2. Why Borrow and Lend?	6
1.3.2. Types of Loan	7
1.3.2.1. Overdraft	7
1.3.2.2. Term Loan	7
1.3.2.3. Revolving Loan	7
1.3.2.4. Bridging Loan	8
1.3.3. Bilateral, Club and Syndicated Loans	8
1.3.3.1. Bilateral Loan	8
1.3.3.2. Club Loan	8
1.3.3.3. Syndicated Loan	9
1.3.4. Sub-participation	9
1.3.4.1. Funded Participation	9

## Table of Contents

1.3.4.2.	Risk Participation	9
1.3.4.3.	Credit Default Swaps	10
1.3.5.	Secured and Guaranteed Loans	10
1.3.6.	Banking Documentation and the LMA	11
1.4.	Introduction to Project Finance	11
1.4.1.	Introduction	11
1.4.2.	Basics	12
1.4.3.	Sponsors	12
1.4.4.	Project Borrowers	13
1.4.5.	Governments	14
1.4.6.	Lenders	15
<b>Chapter 2</b>		
<b>Types of Securities and the Statutory Framework</b>		
<b>Applicable to Securities</b>		<b>19</b>
<i>L.J. Silverentand</i>		
2.1.	Introduction	19
2.2.	Types of Securities	20
2.2.1.	General	20
2.2.2.	Equity Securities	20
2.2.3.	Debt Securities	21
2.2.4.	Hybrid Securities	21
2.2.5.	Derivatives	21
2.2.6.	Statutory Framework	23
2.3.	Historical Perspective	23
2.3.1.	Sectoral Model	23
2.3.2.	Twin Peaks Model	23
2.3.3.	Changes in Legislation	24
2.4.	European Influences	25
2.4.1.	Introduction	25
2.4.2.	Financial Services Action Plan	25
2.4.3.	Lamfalussy Process	26
2.4.4.	Directives Related to the Securities Market	26
2.4.4.1.	General	26
2.4.4.2.	Prospectus Directive	27
2.4.4.3.	MiFID	28
2.5.	Offering of Securities	29
2.5.1.	General	29
2.5.2.	Definition of Securities	29
2.5.3.	Investment Institutions	30
2.5.4.	Exceptions/Exemptions	31
2.5.4.1.	General	31
2.5.4.2.	One Person	31
2.5.4.3.	Money Market Instruments	31
2.5.4.4.	Qualified Investors	32

*Table of Contents*

2.5.4.5.	Less than 100	33
2.5.4.6.	50,000-Exceptions	33
2.5.4.7.	Other Exceptions and Combinations of Exceptions	33
2.6.	Investment Institutions	34
2.6.1.	General	34
2.6.2.	Multiple Prohibitions	34
2.6.3.	Definition of Investment Institution	35
2.6.4.	Exceptions/Exemptions	35
2.6.4.1.	General	35
2.6.4.2.	Qualified Investors	35
2.6.4.3.	Less than 100	35
2.6.4.4.	50,000-Exemptions	36
2.6.4.5.	Designated State-Exception	37
2.7.	Debt Instruments	37
2.7.1.	General	37
2.7.2.	Multiple Prohibitions	38
2.7.3.	Restricted Circle	38
2.7.4.	Professional Market Parties	38
2.7.5.	Issuance of Notes in Accordance with Part 5.1 FSA	39
2.7.6.	Group Exception	40
2.8.	Provision of Investment Services and Performance of Investment Activities	40
2.8.1.	General	40
2.8.2.	Investment Services/Investment Activities	41
2.8.3.	Definition of Financial Instruments	42
2.8.4.	Exceptions/Exemptions	44
2.8.4.1.	General	44
2.8.4.2.	European Passport	44
2.8.4.3.	Designated States-Exception	44
2.9.	Conclusion	45
<b>Chapter 3</b>		
<b>Primary and Secondary Offerings of Securities</b>		<b>47</b>
<i>H.B.W. Beerlage &amp; J.H. Horsmeier</i>		
Introduction		47
Primary Markets		47
3.1.	Prospectus	47
3.1.1.	History	47
3.1.2.	Requirements	48
3.1.3.	Offer to the Public	48
3.1.4.	Admission to Trading on a Regulated Market	49
3.1.5.	Securities	50

## *Table of Contents*

3.2.	Contents of a Prospectus	50
3.2.1.	Prospectus Regulation	51
3.2.2.	Base Prospectuses	53
3.2.3.	Incorporation by Reference	54
3.2.4.	Supplement	54
3.3.	Prospectus Approval	55
3.3.1.	Authority of the AFM	56
3.3.2.	Timetable	57
3.3.3.	Publication	58
3.4.	Advertising	59
3.5.	Exemptions from Prospectus Requirements	60
3.5.1.	General Exemptions	60
3.5.2.	Offer to the Public in the Netherlands	61
3.5.3.	Admission to Trading on a Regulated Market in the Netherlands	62
3.6.	European Passport	63
3.6.1.	Passporting from the Netherlands	64
3.6.2.	Passporting into the Netherlands	65
	Secondary Markets	66
3.7.	Offering Securities in the Secondary Market	66
3.7.1.	Section 54(1) Exemption Regulation	66
3.7.2.	Section 54(2) Exemption Regulation	68
3.7.3.	Section 54(3) Exemption Regulation	68
	Proposed Changes to the Prospectus Directive	68
3.8.	Changes Proposed by the European Commission	68
3.8.1.	Summary	69
3.8.2.	Rights Issues	70
3.8.3.	Home Member State	70
3.8.4.	Retail Cascade Offers	70
3.8.5.	Other	71
	Finally	71
3.9.	Conclusion	71
	<b>Chapter 4</b>	
	<b>The Regulation of Investment Firms in the Netherlands</b>	<b>73</b>
	<i>W.J. Horsten</i>	
4.1.	Introduction	73
4.2.	Investment Firms: Providing Investment Services and Performing Investment Activities	74
4.2.1.	Providing Investment Services	74
4.2.2.	Performing Investment Activities	75
4.3.	Financial Instruments	75

*Table of Contents*

4.4.	Authorisation as an Investment Firm	76
4.4.1.	Exemptions from Licence Requirement	76
4.4.2.	Licence Requirements	78
4.4.2.1.	Competence	79
4.4.2.2.	Trustworthiness	79
4.4.2.3.	Policy Regarding Integrity in the Conduct of Business	79
4.4.2.4.	Minimum Number of Persons that Determine the Day-to-Day Policy and the Place from Which They Conduct Their Activities	80
4.4.2.5.	Control Structure	80
4.4.2.6.	Manner in Which the Conduct of Business is Organised	80
4.4.2.7.	Adequate Measures for the Protection of the Rights of Clients	82
4.4.2.8.	Adequate Policy Regarding the Prevention of Conflicts of Interest	83
4.4.2.9.	Minimum Own Funds	83
4.4.2.10.	Solvency	83
4.4.2.11.	Qualifying Holdings in Investment Firms	84
4.4.2.12.	Exemptions and Dispensation	84
4.4.3.	Granting and Withdrawal of Licence	85
4.4.4.	Ancillary Services	86
4.5.	Certain Organisational and Operational (Conduct of Business) Requirements	86
4.5.1.	Client Classification	86
4.5.1.1.	Professional Clients	87
4.5.1.2.	Eligible Counterparties	87
4.5.1.3.	Non-professional Clients	87
4.5.1.4.	Consequences of Classification; Eligible Counterparties	88
4.5.1.5.	Classifying Large Undertakings as Eligible Counterparty	88
4.5.1.6.	Opt-Up or Opt-Down	88
4.5.2.	Provision of Information	90
4.5.3.	KYC and Advising or Individual Portfolio Management: Suitability	91
4.5.4.	KYC and Execution Only: Appropriateness	92
4.5.5.	Further Duty of Care	93
4.5.6.	Client File	94
4.5.7.	Best Execution	95
4.5.8.	Client Order Handling	97
4.5.9.	Inducements	98
4.5.10.	Dispensation	98

*Table of Contents*

<b>Chapter 5</b>		
<b>Clearing and Settlement in the Netherlands</b>		<b>99</b>
<i>B.J.A. Zebregs</i>		
5.1.	General	99
5.1.1.	Introduction	99
5.1.2.	Consolidation of Infrastructure	100
5.1.2.1.	Consolidation of Systems	100
5.1.3.	A New Competitive Landscape	101
5.2.	Clearnet	103
5.2.1.	Main Functions Clearnet	103
5.2.1.1.	Clearing Member Structure	104
5.2.1.2.	The Clearing Process	105
5.2.2.	Contractual Documentation	108
5.2.2.1.	Applicable Law	108
5.2.3.	General and Individual Clearing Members	109
5.2.3.1.	Licence and Notification Requirements	110
5.2.3.2.	Licence Criteria	111
5.2.4.	Admission of Securities	112
5.2.5.	Collateral and Margins	113
5.2.5.1.	Guarantee Fund	115
5.2.6.	Net Fails and Events of Default	115
5.2.7.	Supervision of Clearnet	116
5.2.8.	Finality	117
5.3.	Euroclear Nederland	118
5.3.1.	Main Functions	118
5.3.2.	Contractual Documentation	120
5.3.2.1.	Applicable Law	121
5.3.3.	Admitted Institutions	121
5.3.4.	Admission of Securities	123
5.3.4.1.	Restrictions	124
5.3.4.2.	Admission Procedure	125
5.3.5.	Deposits and Withdrawals	127
5.3.5.1.	The Master Deed	128
5.3.6.	Settlement on the ESES Platform	129
5.3.6.1.	Securities Leg and CSD of Reference	129
5.3.6.2.	Cash Leg and the Integrated Model	130
5.3.6.3.	Target2 Securities	132
5.3.7.	International Network	133
5.3.8.	Supervisory Regime Euroclear Nederland	133
5.3.9.	Finality	134

<b>Chapter 6</b>		
<b>Custody of Securities and Book-Entry Transfer of Rights</b>		
<b>Regarding Securities</b>		<b>135</b>
<i>B.F.L.M. Schim</i>		
6.1.	Introduction	135
6.2.	Background of Securities Custody Structures	136
6.2.1.	Immobilisation and Dematerialisation of Securities	136
6.2.2.	Protecting Investors from Intermediary Risk	137
6.2.3.	Book-Entry Transfers of (Rights Regarding) Securities	138
6.2.4.	Structure of Book-Entry Securities Systems	138
6.3.	Regulatory Framework for Custody of Securities in the Netherlands	139
6.3.1.	General	139
6.3.2.	Sections 6:14 et seq. of the Further Regulation	140
6.4.	The Securities Giro Transfer Act	141
6.4.1.	Scope of Applicability	141
6.4.1.1.	Financial Instruments Eligible for Designation as Securities	142
6.4.1.2.	Institutions Eligible for Admission as an Admitted Institution	143
6.4.1.3.	Practical Complications in Respect of the Limited Scope of Applicability of the SGTA; Proposed Amendments to the SGTA	143
6.4.2.	Structure of the SGTA	145
6.4.3.	The Co-ownership Regime	145
6.4.3.1.	Sections 12 and 38 SGTA	145
6.4.3.2.	Elements of a Collective Deposit and a Giro Deposit	147
6.4.3.3.	Short Overview of the Rights of a Co-owner in a Collective Deposit	148
6.4.4.	Issues of Securities for Inclusion in a Collective Deposit	149
6.4.4.1.	Proposed Amendment to the SGTA	151
6.4.5.	Withdrawal of Securities	151
6.4.5.1.	The Notion of Withdrawal of Securities	151
6.4.5.2.	Withdrawal of securities in the Case of a Shortfall of Securities	152
6.4.5.3.	Making Withdrawal of Securities Impossible	153
6.4.6.	The Book-Entry Delivery of a Co-ownership Interest	154
6.4.6.1.	Sections 16, 17 and 41 SGTA: General Remarks	154
6.4.6.2.	Legal Nature of a Book-Entry ‘Delivery’	155

## Table of Contents

6.4.7.	Recourse against a Co-ownership Interest in a Collective Deposit	158
6.4.7.1.	Pledge	158
6.4.7.2.	Attachment	160
6.4.8.	Dematerialisation of Securities	161
6.4.8.1.	Global Certificates	161
6.4.8.2.	Registered Securities	162
6.4.8.3.	Proposed Amendments to the SGTA	162
6.4.9.	Shareholder Rights	163
6.4.9.1.	Who Is the Shareholder?	164
6.4.9.2.	Exercising Shareholder Rights	165
6.5.	Special Securities Custody Entities	166
6.5.1.	Practical Importance of Special Securities Custody Entities	166
6.5.2.	Legal Framework and Main Features of Special Securities Custody Entities	167
6.5.3.	Some Practical Complications with Respect to Special Securities Custody Entities	168
6.6.	The Conflict of Laws	168
6.6.1.	Introduction	168
6.6.2.	Section 16 Conflict of laws (Property) Act: PRIMA	169

## **Chapter 7** **Listing and Delisting** **171**

*T.M. Stevens*

7.1.	The Euronext Amsterdam Securities Market	172
7.1.1.	NYSE Euronext Regulatory Structure	172
7.1.2.	Euronext Amsterdam Stock Exchange Regulation	173
7.1.3.	Types of Markets Operated by Euronext Amsterdam	175
7.1.4.	Types of Securities that Can Be Listed on Euronext Amsterdam	176
7.2.	Admission to Listing on Euronext	177
7.2.1.	Introductions and Follow-On Admissions	177
7.2.2.	Listing Agent	178
7.2.3.	Listing Agreement	179
7.2.4.	Admission Procedure	180
7.2.5.	Contents of Admission Request	181
7.3.	Introductions	182
7.3.1.	General Admission Requirements	182
7.3.2.	Additional Requirements for Shares, Depositary Receipts for Shares and Equity Securities	184
7.3.3.	Additional Listing Requirements for Corporate Bonds	185
7.3.4.	Additional Listing Requirements for Securities Issued by Investment Funds and Investment Companies	185

## Table of Contents

7.3.5.	Additional Listing Requirements for Other Securities	186
7.4.	Conditional Admission ('If-and-When-Issued/Delivered')	186
7.5.	Follow-On Admissions	187
7.6.	Admission to Listing on Alternext Amsterdam	189
7.6.1.	Admission Criteria	189
7.6.2.	Admission Procedure	190
7.7.	Suspension of Listing	191
7.8.	Delisting	191
7.8.1.	Delisting at the Initiative of Euronext	192
7.8.2.	Delisting at the Initiative of the Issuer	192
<b>Chapter 8</b>		
<b>Takeover Bids and Anti-takeover Devices in the Netherlands</b>		<b>195</b>
<i>M.J.G.C. Raaijmakers &amp; P.A. van der Schee</i>		
8.1.	Netherlands Regulatory Framework on Takeover Bids: Introduction	195
8.1.1.	The Regulatory History of Public Takeovers	195
8.1.2.	From 'Self Regulation' to Statutory Rules	196
8.1.3.	The Takeover Directive and Its Implementation in Netherlands Law	196
8.1.4.	The Scope of Netherlands Regulation on Public Takeovers	197
8.1.5.	Public Oversight by the AFM and Its Means for Enforcement: General	198
8.1.6.	AFM Oversight on Public Takeover Bids	199
8.1.7.	The Role of the Judiciary (Enterprise Chamber of the Amsterdam Court of Appeal)	200
8.2.	Typology of Offers: Mandatory Bids, Competing Bids, Friendly and Unfriendly Bids	201
8.2.1.	Definitions and Different Categories of 'Public Offer'	201
8.2.2.	Mandatory Bid (Section 5, 13th Directive; Sections 5:70–5:73, 5:80a and 5:80b FSA; Section 24-26 Decree and Section 2 Exemption Decree Takeover Bids FSA ( <i>Vrijstellingsbesluit overnamebiedingen Wft</i> ))	202
8.2.3.	Exemptions from Mandatory Bid (Sections 5:71(1) and (2), 5:72(3), 5:81(2) FSA and Section 2 Exemption Decree Takeover Bids FSA)	203
8.2.4.	Competing Bids	203
8.3.	Disclosure and Other Rules Preceding a Public Offer	204
8.3.1.	Preparation	204
8.3.2.	Building a 'Starting Position'; Disclosure of Holdings and Acquisitions	204

## Table of Contents

8.3.3.	General Rules on Disclosure of Price Sensitive Information Remain Applicable in Pre-bid Period; Put Up or Shut Up	206
8.4.	Public Announcement of a Bid	206
8.4.1.	When Does a First Announcement of a Public Bid Have to Be Made?	206
8.4.2.	Announcement Request for AFM Approval (within Twelve Weeks of the First Announcement)	207
8.4.3.	Disclosure Rules on Transactions in Target's Securities after First Announcement	207
8.4.4.	Certain Funds	207
8.5.	Offering Circular and Offer Itself	208
8.6.	Approval by the AFM	208
8.7.	Definitive Offer	208
8.8.	The Response of the Target and Meeting of Shareholders to Discuss the Offer; Position Statement	209
8.9.	Acceptance and Execution	209
8.10.	Final Execution	209
8.11.	Extension of Bid and Statutory Squeeze Out in the Case of >95%	210
8.12.	Alternative Squeeze Out Mechanisms (<95%)	210
8.13.	Sell-Out Rights (To Protect Remaining Small Minority)	211
8.14.	Contested Takeovers and Anti-takeover Mechanisms	211
8.14.1.	A Contested Takeover and Anti-takeover Devices: Corporate Law and Securities Regulation	211
8.14.2.	Protective Devices	213
8.14.3.	Takeover of 'Managerial Control'	214
8.14.4.	Activating Anti-takeover Devices: The AFM and Court Actions (Enterprise Chamber)	214
8.14.5.	The 'RNA Rules' of the Supreme Court: Proportionality and Limitations in Time	215
<b>Chapter 9</b>		
<b>Investment Funds</b>		<b>217</b>
<i>M.C.A. van den Nieuwenhuijzen</i>		
9.1.	Introduction	217
9.2.	Investment Fund Developments	217
9.3.	Basics of an Investment Fund	220
9.3.1.	Collective Investment	220
9.3.2.	The Activities of an Investment Fund Must Qualify as 'Investing'	221
9.3.3.	Open-End and Closed-End Investment Funds	222
9.3.4.	Types of Fund Vehicles	224
9.3.5.	Types of Funds	225

## Table of Contents

9.3.5.1.	Buy-out Fund	225
9.3.5.2.	Venture Capital Fund	226
9.3.5.3.	Hedge Fund	226
9.3.5.4.	Fund of Funds	226
9.3.5.5.	Master-Feeder	226
9.3.5.6.	Retail Fund	227
9.3.5.7.	Exchange Traded Fund	227
9.4.	The Dutch Regulatory Framework for an Investment Fund	227
9.4.1.	Non-UCITS	227
9.4.1.1.	The Scope of Section 2:65 FSA	227
9.4.1.2.	Exceptions to, Exemptions and Dispensations from Section 2:65 FSA	228
9.4.1.3.	Dispensation	229
9.4.2.	UCITS	229
9.4.2.1.	Offering units in a Dutch UCITS to investors in the Netherlands	230
9.4.2.2.	Offering units in a non-Dutch UCITS to investors in the Netherlands	230
9.4.3.	Adequate Supervision Funds	230
9.5.	Future developments	231
9.5.1.	Proposed EU Directive for Managers of Alternative Investment Funds	231
9.5.2.	Voluntary Supervisory Regime for Investment Funds	235
9.5.3.	Wild West Sign ( <i>wildwestbordje</i> )	236
9.6.	Fund Governance	236
9.6.1.	Committee Winter	236
9.6.2.	DUFAS Fund Governance Principles	237
9.6.3.	The Dutch Corporate Governance Code	237
<b>Chapter 10</b>		
<b>Derivatives</b>		<b>239</b>
<i>M.S. Lotay</i>		
10.1.	Introduction	239
10.2.	What Is a Derivative?	240
10.3.	Derivatives and Jargon	241
10.4.	What Do Derivatives Do?	242
10.4.1.	Risk Management and ‘Hedging’	242
10.4.2.	Speculation and Investment	243
10.4.3.	Transactional Efficiency	244
10.4.4.	Exposures to Different Markets and Assets	244
10.4.5.	Price Discovery	245
10.4.6.	Economic and Social Growth	245
10.5.	The Derivative ‘Building Blocks’	246
10.6.	Forwards	246

## *Table of Contents*

10.6.1.	Introduction	246
10.6.2.	Commodity Forward: Worked Example	248
10.6.3.	Currency Forward: Worked Example	251
10.7.	Futures	253
10.7.1.	Introduction	253
10.7.2.	History	253
10.7.3.	Exchange Traded and Over-the-Counter Derivatives	254
10.7.4.	Margin	255
10.8.	Options	256
10.8.1.	Introduction	256
10.8.2.	Call Option and Put Option	256
10.8.3.	Option Styles	257
10.8.4.	Commodity Option: Worked Example	257
10.9.	Swaps	260
10.9.1.	Introduction	260
10.9.2.	Interest Rate Swap: Worked Example	260
10.9.3.	Comparative Advantage	263
10.9.4.	Counterparty Risk	263
10.9.5.	Interest Rate Caps, Floors and Collars	264
10.10.	Derivatives, Leverage and Exposure Mitigation	266
10.11.	Case Study: IBM and World Bank Swap	267
10.11.1.	Introduction	267
10.11.2.	IBM and the World Bank: Funding Problems	267
10.11.3.	Comparative Advantages	268
10.11.4.	The Result	270
10.11.5.	Conclusion	270
10.12.	Case Study: The Fall of Barings Bank	271
10.12.1.	Introduction	271
10.12.2.	Directional Play and Straddling	271
10.12.3.	The Failure to Hedge	273
10.12.4.	Bad Situation Made Worse	273
10.12.5.	Conclusion	275
10.13.	Derivatives Market and Controversy	276
10.14.	Credit Derivatives	277
10.14.1.	Introduction	277
10.14.2.	Credit Derivatives Terminology	278
10.14.3.	What Are Credit Derivatives?	278
10.14.4.	Credit Derivatives as ‘Derivatives’	280
10.14.5.	Credit Events	281
10.14.6.	Factors that Influence the Cost of Protection; the ‘Risk Premium’	282
10.14.7.	No Legal Transfer of Reference Obligation and Flexibility	282
10.14.8.	Business Objectives	283
10.14.9.	Credit Risk Transfer	283

*Table of Contents*

10.14.10.	Regulatory Capital Efficiency	285
10.14.11.	Investment and Speculation	286
10.14.12.	Who Uses Credit Derivatives and Why?	287
10.14.12.1.	Banks	287
10.14.12.2.	Companies	289
10.14.12.3.	Investors	289
10.14.12.4.	Credit Derivatives Documentation	289
10.14.13.	Credit Derivative Products	290
10.14.13.1.	Credit Default Swaps	290
10.14.13.1.1.	Fixed Amount and Floating Rate Payer Calculation Amount	291
10.14.13.1.2.	Settlement Method	291
10.14.13.1.3.	Physical Settlement	291
10.14.13.1.4.	Cash Settlement	292
10.14.13.1.5.	Back-to-Back Hedging	293
10.14.13.1.6.	Protection Period and Maturity	294
10.14.13.1.7.	Basket CDS	294
10.14.13.1.8.	Credit Risk Transfer Not Eliminated	295
10.14.13.2.	Credit Linked Notes	295
10.14.13.3.	Securitisation through CLNs	297
10.14.13.4.	Total Return Swaps	299
10.14.14.	The Credit Derivatives Market and Controversy	300
10.15.	Summary	302
<b>Chapter 11</b>		
<b>Repos and Securities Lending</b>		<b>303</b>
<i>W.A.K. Rank</i>		
11.1.	Introduction	303
11.2.	Documentation	308
11.2.1.	General	308
11.2.2.	GMRA	308
11.2.3.	GMSLA	310
11.3.	Validity and Enforceability under Dutch Law	311
11.3.1.	General	311
11.3.2.	Recharacterisation	312
11.3.2.1.	GMRA: Transfer of Purchased Securities	312
11.3.2.2.	GMRA: Transfer of Margin Securities	318
11.3.2.3.	GMSLA: Transfer of Loaned and of Margin Securities	318
11.3.2.4.	Limitation of Recharacterisation Risk	319

## Table of Contents

11.3.3.	Close-Out Netting Provisions	319
11.3.3.1.	No Insolvency Proceedings Have Occurred	320
11.3.3.2.	Insolvency Proceedings Have Occurred	320
11.3.3.2.1.	Insolvency Proceedings within the Scope of the Banks Insolvency Act	320
11.3.3.2.2.	Other Insolvency Proceedings Outside the Scope of the Banks Insolvency Act	322
11.3.3.3.	Early Termination	323
11.3.3.4.	Set-Off	325
11.3.3.5.	Currency	325
11.3.3.6.	Fixation	326
11.3.3.7.	Fraudulent Conveyance (' <i>Actio Pauliana</i> ')	326
11.3.3.8.	Freeze	328
11.3.3.9.	Interest	329
11.3.4.	Choice of Law and Jurisdiction	329
11.3.5.	Attachments	330
11.4.	Regulatory Issues	332
11.5.	Conclusion	333
<b>Chapter 12</b>		
<b>Securitisation</b>		<b>335</b>
<i>R.E.G. Masman &amp; P.N.J. van Welzen</i>		
12.1.	Introduction	335
12.2.	Transaction Structures	336
12.2.1.	True Sale Transaction	336
12.2.2.	Secured Loan Transaction	337
12.2.3.	Synthetic Transaction	337
12.2.4.	Funding of Transactions	338
12.2.4.1.	Type of Securities	338
12.2.4.2.	Conduit Transactions	339
12.2.4.3.	Term Transactions	341
12.2.4.4.	Information about Transactions	343
12.3.	Dutch Special Purpose Vehicles	344
12.3.1.	Orphan versus Originator SPV	344
12.3.2.	Management	345
12.3.3.	Bankruptcy Remoteness	346
12.3.4.	Regulatory Position	347
12.3.4.1.	Dutch Banking Regulations	347
12.3.4.2.	Prospectus Requirements	348

*Table of Contents*

	12.3.4.3.	Consumer Credit Regulations	349
	12.3.4.4.	Data Protection and Confidentiality Regulations	349
	12.3.4.5.	Certain Mandatory Reporting Requirements	350
	12.3.4.6.	Licensing Issues	350
12.4.	True Sale Transaction		351
	12.4.1.	Legal Structure	351
		12.4.1.1. General	351
		12.4.1.2. Transfer Techniques	352
	12.4.2.	Transfer Restrictions	353
	12.4.3.	Security	354
	12.4.4.	Selected Legal Issues	356
		12.4.4.1. Impact of Insolvency on Assignment	356
		12.4.4.2. Set-Off and Deduction	357
		12.4.4.3. Interest Rate Reset	358
12.5.	Secured Loan Transaction		359
	12.5.1.	Legal Structure	359
		12.5.1.1. General	359
		12.5.1.2. Whole Business Securitisation	361
		12.5.1.3. Secured Loan Transactions in the Netherlands	361
	12.5.2.	Security	364
	12.5.3.	Selected Legal Issues	365
		12.5.3.1. Voidable Preference ( <i>Pauliana</i> )	365
		12.5.3.2. Cool-Off Period ( <i>Afkoelingsperiode</i> )	365
		12.5.3.3. Future Receivables	366
		12.5.3.4. Miscellaneous	367
12.6.	Synthetic Transaction		368
	12.6.1.	Legal Structure	368
	12.6.2.	Credit Default Swap	369
	12.6.3.	Selected Legal Issues	371
		12.6.3.1. Re-characterisation Risk	371
		12.6.3.2. Conflict of Interests	373
		12.6.3.3. Confidentiality	375
12.7.	Credit Enhancement		377
	12.7.1.	General	377
	12.7.2.	Subordination	377
	12.7.3.	Overcollateralisation	378
	12.7.4.	Reserves	379
	12.7.5.	External Support to SPV	380
	12.7.6.	External Support to the SPV Creditors	380
12.8.	Transaction Security		381
	12.8.1.	Legal Structure	381
	12.8.2.	Security Types	382

## *Table of Contents*

12.8.3.	Security Trustee	383
12.8.4.	Selected Legal Issues	384
12.8.4.1.	Enforcement of Security	384
12.8.4.2.	Impact of Insolvency on Security	385
<b>Chapter 13</b>		
<b>Covered Bonds</b>		<b>387</b>
<i>R.A. Stegeman &amp; J.C. Westermann</i>		
13.1.	Introduction	387
13.1.1.	Covered Bonds in a Nutshell	387
13.1.2.	History	388
13.1.3.	Credit Crunch	388
13.1.4.	Regulated versus Contractual Covered Bonds	389
13.1.5.	Covered Bonds versus Securitisation	390
13.2.	How Covered Bonds Work	391
13.2.1.	Segregated Structure	391
13.2.2.	Guarantee Support Agreement	393
13.2.3.	Guarantee	395
13.2.4.	Cover Assets	396
13.2.5.	Asset and Liability Management	397
13.3.	Specific Covered Bond Regulations	398
13.3.1.	Section 22(4) UCITS Directive	398
13.3.2.	Consultation Process	399
13.3.3.	Regulatory Framework	399
13.3.4.	Regulated Covered Bonds	401
13.3.5.	UCITS- & CRD-Compliance	402
13.3.6.	Registration by DNB	404
13.3.7.	Ongoing Administration and Reporting Obligations	405
13.3.8.	Deregistration	406
13.4.	Some Benefits of Regulated Covered Bonds	406
13.4.1.	ECB Monetary Policy Operations	406
13.4.2.	Regulatory	407
<b>Chapter 14</b>		
<b>Caretaking Duties and Investment Firms</b>		<b>411</b>
<i>S.B. van Baalen</i>		
14.1.	Introduction	411
14.2.	Some General Remarks on Private Law Caretaking Duties	412
14.2.1.	Contractual Basis for Caretaking Duties	412
14.2.2.	Fiduciary Relationship	413
14.2.3.	General Benchmark	415
14.3.	Some General Remarks on Public Law Caretaking Duties	416

## Table of Contents

14.3.1.	Financial Supervision Act ( <i>Wet op het financieel toezicht</i> )	416
14.3.2.	The Investment Firm	417
14.3.3.	Counterparties	420
14.4.	Pre-contractual Information and Documentation	422
14.4.1.	Market Information and Advertisement	422
14.4.2.	Pre-contractual Duties to Disclose Information	424
14.4.3.	Know Your Customer	426
14.4.4.	Client Registration and Documentation	428
14.5.	Ongoing Caretaking Duties	429
14.5.1.	Ongoing Duties to Disclose	429
14.5.2.	Suitability	430
14.5.3.	Best Execution	432
14.5.4.	Provisions and Churning	435
14.5.5.	Caretaking Duties, Third Parties and Tied Agents	435
14.6.	Breach of Caretaking Duties	436
14.6.1.	Legal Grounds	436
14.6.2.	Remedies	438
14.6.3.	Contributory Negligence	440

## Chapter 15

### Prospectus Liability in the Netherlands: Consequences of the Unfair Commercial Practice Rules

(*Wet Oneerlijke Handelspraktijken, Wet OHP*)

443

*T.M.C. Arons & A.C.W. Pijls*

15.1.	Introduction	443
15.2.	Prospectus Liability Procedure	445
15.3.	Legal Obligation to Publish a Prospectus	446
15.4.	Book Building	448
15.5.	Legal Basis of Prospectus Liability	449
15.5.1.	Contractual Liability	449
15.5.2.	General Liability in Tort	449
15.5.3.	Specific Liability in Tort Claims	450
15.6.	The Unfair Commercial Practices Rules	452
15.6.1.	General Description	452
15.6.2.	Which Parties in the IPO Process Qualify as Traders?	454
15.6.3.	Information Published and Distributed Outside the Prospectus	457
15.6.4.	When Is a Commercial Practice Unfair?	459
15.6.5.	Burden of Proof	461
15.7.	The Element 'Misleading'	464
15.7.1.	Double Standards	464
15.7.2.	Private Law Misleading Norm	466

## Table of Contents

15.7.3.	Relationship between the Misleading Element and the Other Elements of Liability in Tort	468
15.8.	Fault	470
15.9.	Causation and Damages	471
15.9.1.	Introduction	471
15.9.2.	Two Actionable Claims	472
15.9.3.	First Claim	473
15.9.4.	Second Claim	475
15.9.5.	Three Possibilities to Substantiate the Second Claim	477
15.9.6.	Own Fault Doctrine	480
15.9.7.	European Perspective towards causation requirement	480
15.10.	Disclaimers	481
15.11.	Private International Law and Prospectus Liability Claims	482
15.12.	Concluding Remarks	484
<b>Chapter 16</b>		
<b>Litigation and Securities Law</b>		<b>487</b>
<i>G.P. Roth &amp; M. van Eersel</i>		
16.1.	Introduction	487
16.1.1.	Securities Litigation in the Netherlands	487
16.1.2.	Definition: Terminology	488
16.1.3.	Market Players: Potential Litigators	489
16.1.4.	Legal Areas	490
16.2.	Private Law	491
16.2.1.	Dutch Private Law Framework	491
16.2.2.	Matter in Dispute	491
	16.2.2.1. The Provision of Information by Issuers, Investment Institutions and Public Takeover Bidders	491
	16.2.2.2. Duty of Care of Investment Firms	494
	16.2.2.3. Unfair Commercial Practices	498
16.2.3.	Types of Procedure	499
	16.2.3.1. Individual Proceedings	499
	16.2.3.1.1. Civil Court Judge	499
	16.2.3.1.2. Enterprise Chamber	502
	16.2.3.1.3. Alternative Dispute Resolution	502
	16.2.3.1.3.1. Financial Services Complaints Tribunal (KIFID)	503
	16.2.3.1.3.2. Arbitration Committee	504
	16.2.3.2. Collective Proceedings	504
16.3.	Administrative Law	506

*Table of Contents*

16.3.1.	Dutch Regulatory Law Framework	506	
	16.3.1.1. FSA	506	
	16.3.1.2. GALA	506	
	16.3.1.3. Matter in Dispute	507	
16.3.2.	Armamentarium of the AFM	507	
	16.3.2.1. Supervision	507	
	16.3.2.2. Enforcement	508	
16.3.3.	Legal Protection: Regulatory or Administrative Proceedings	509	
16.4.	Private Law and Administrative Law in Concert: Dangerous Liaisons	512	
	16.4.1. Effect of Violations of the FSA in Relationships Governed by Private Law	512	
	16.4.2. Disclosure of Voting Rights, Capital, Major Holdings and Capital Interest in Issuers	513	
	16.4.3. Other Conflicts	513	
16.5.	Criminal Law	514	
16.6.	Administrative Law and Criminal Law in Concert: Dangerous Liaisons (ii)	516	
	16.6.1. Punitive Sanctions in Administrative Proceedings	516	
		16.6.1.1. Principle of Proportionality	517
		16.6.1.2. Rights of Defence	517
		16.6.1.3. Requisite of Guilt	517
		16.6.1.4. Principle of Legality	518
	16.6.2. Publication of Administrative Fines	518	
	16.6.3. <i>Una Via</i>	518	
16.7.	Disciplinary Proceedings	519	
16.8.	Concluding Remarks	520	
	<b>Index</b>	<b>523</b>	

## Chapter 13

# Covered Bonds

*R.A. Stegeman\* & J.C. Westermann\*\**

### 13.1. INTRODUCTION<sup>1</sup>

#### 13.1.1. COVERED BONDS IN A NUTSHELL

Covered bonds are generally bonds which are (a) issued by a bank, and (b) collateralised ('covered') by a pool of high quality cover assets. Investors in covered bonds have dual recourse: first to the issuing bank and thereafter, if the issuing bank cannot perform, to the cover assets. Due to their dual recourse nature and certain additional safeguards,<sup>2</sup> covered bonds are regarded as very safe instruments for investors. For issuing banks covered bonds are a means of attracting long-term, relatively cheap funding. As the covered bonds are collateralised by cover assets, the issuing bank usually needs to pay less interest than it would have to pay on uncovered bonds.

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1. For more detailed information on covered bonds generally please see the European Covered Bond Factbook which is freely available on the internet (<[www.ecbc.hypo.org](http://www.ecbc.hypo.org)>).
2. Such as eligibility criteria for cover assets, rules on the minimum level of 'over-collateralisation' (meaning in short the amount by which the value of the cover assets exceeds the outstanding principal amount of the covered bonds), regulatory supervision, rating agency surveillance and protection mechanisms against market and liquidity risk.

The main purpose of collateralising the covered bonds by cover assets is to ensure that even if the issuer becomes insolvent, the cash flows under the covered bonds are not disrupted or accelerated.<sup>3</sup> In other words, the intent is that when the issuer becomes insolvent, the cover assets generate sufficient and timely cash flows to ensure that the covered bondholders will not only get their money back, but will also receive the relevant payments of principal and interest on the originally scheduled payment dates. The cover assets are usually mortgage loans or public sector loans (such as government bonds).

### 13.1.2. HISTORY

Covered bonds have a long history, going back to the eighteenth century and before. They have their roots in ancient Greek mortgage lending and Dutch and Italian bonds. In the nineteenth century covered bonds played an important role for bank funding across Europe. That changed in the course of the twentieth century, when covered bonds became less important as the inter-bank market and private bank deposits grew.

In 1995 jumbo covered bonds were introduced. ‘Jumbo’ in short means that the covered bonds (a) have a total issuance size of at least 1 billion; (b) are euro-denominated; and (c) have a bullet maturity and a fixed annual coupon.<sup>4</sup> The first jumbo covered bonds were issued out of Germany.<sup>5</sup> In the Netherlands the first jumbo covered bonds were issued in 2005, by ABN AMRO.

Following the introduction of jumbo covered bonds, the covered bond market has become the most important segment of privately issued bonds in the European capital markets. The total volume of covered bonds outstanding as per the end of 2008 was approximately EUR 2.4 trillion for covered bonds issued out of Europe and EUR 21 billion for covered bonds issued out of the Netherlands.

### 13.1.3. CREDIT CRUNCH

Initially when the credit crunch started in 2007, covered bonds were relatively resilient. That changed with the collapse of Lehman Brothers on 15 September 2008. Thereafter (a) issuance of jumbo covered bonds stopped for the remainder of 2008, (b) secondary trading of covered bonds was hampered because market

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3. ‘Acceleration’ of a debt means that, due to for example the insolvency of the debtor, the creditor demands full and immediate payment of the entire outstanding balance of the debt prior to the scheduled maturity of such debt.

4. ‘Bullet maturity’ and ‘fixed annual coupon’ mean that the bonds are to be repaid in one instalment on their maturity date and carry interest which is payable annually at a fixed rate.

5. German covered bonds are called *Pfandbriefe*.

making by traders<sup>6</sup> (which had already seen various interruptions since the start of the credit crunch) shut down completely and (c) spreads widened considerably.<sup>7</sup>

In some European countries governments introduced specific national measures to enable covered bond issuance even when the market was closed, ranging from government guarantee schemes (e.g., Ireland) to special central bank repo schemes (e.g., Denmark and Sweden) and government asset purchase schemes (e.g., the UK). In the Netherlands a government guarantee scheme was introduced too, but it enabled government guarantees for uncovered bank bonds only, and not for covered bonds.

In January 2009 the covered bond market was one of the first non-state guaranteed bank debt capital markets to come back to life, although initially at interest rate levels which were so high that they were previously thought impossible for covered bonds. The market has been recovering slowly but surely since. It was kick-started when the European Central Bank (ECB) announced its EUR 60 billion covered bond purchase programme in May 2009.<sup>8</sup> Under that programme covered bonds issued within the euro area are purchased by the ECB in the primary and secondary market to help reviving the market.

#### 13.1.4. REGULATED VERSUS CONTRACTUAL COVERED BONDS

In most European countries, covered bond issuance is regulated by specific regulation implementing the relevant provisions of the UCITS Directive and the CRD.<sup>9</sup> In the Netherlands, covered bond regulation was implemented relatively late, in 2008. In this respect a distinction needs to be made between covered bonds which are issued pursuant to such specific covered bond regulation (*Regulated Covered Bonds*) and covered bonds which are issued outside the scope of such specific covered bond regulation (*Contractual Covered Bonds*).

Until about seven years ago the jumbo covered bond market consisted exclusively of Regulated Covered Bonds. This changed in 2003, when the first jumbo Contractual Covered Bonds were issued out of the UK. At the time no specific covered bond regulation existed in the UK. The Contractual Covered Bonds were eyed with suspicion by some traditional issuers of Regulated Covered Bonds. They

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6. Under the Dutch Financial Supervision Act (*Wet op het financieel toezicht*; FSA) a ‘market maker’ is in short defined as a party presenting itself in the financial markets as willing to buy and sell financial instruments at prices defined by it.

7. ‘Widening of spreads’ in short means that investors would only purchase covered bonds in the primary or secondary market if the covered bonds carried interest rates or yields that were substantially higher than before.

8. Decision of the European Central Bank of 2 Jul. 2009 on the implementation of the covered bond purchase programme (ECB/2009/16).

9. UCITS Directive means the Undertakings for Collective Investment in Transferable Securities Directive (85/11/EEC). CRD means the Capital Requirements Directives, comprising (a) the Banking Consolidation Directive (2006/48/EC; the BCD), and (b) the Capital Adequacy Directive (2006/49/EC; the CAD).

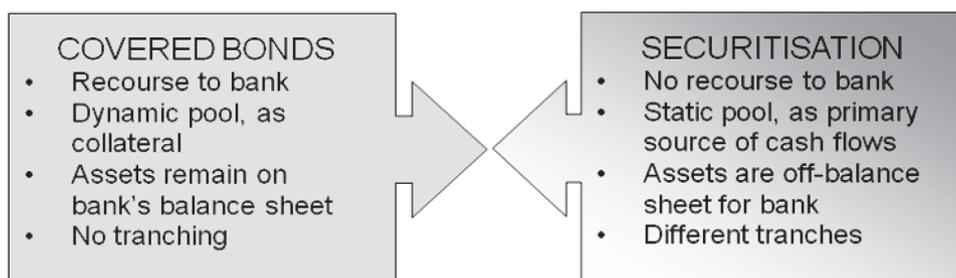
feared, among other things, that the widening of the spectrum of covered bond categories might result in a widening of the spreads<sup>10</sup> payable on their covered bonds. However, the Contractual Covered Bonds met with enthusiasm from many other banks and investors and the UK example was soon followed by banks from other countries such as Canada, France, Germany, Italy, Switzerland, the US and the Netherlands (starting with ABN AMRO in 2005).

Like the UK, the Netherlands did not have specific covered bond regulation when the first jumbo Contractual Covered Bonds were issued. Since the introduction of specific Dutch covered bond regulation in 2008, most of the Dutch Contractual Covered Bonds have been registered by the Dutch Central Bank (*De Nederlandsche Bank N.V.*; DNB) and have thus become Regulated Covered Bonds.

### 13.1.5. COVERED BONDS VERSUS SECURITISATION

Covered bonds and securitisation are different animals. For example, covered bonds are issued by a bank, whereas securitisation notes are issued by a special purpose vehicle. Also, the cover assets backing covered bonds remain on the balance sheet of the bank and are a dynamic pool, the quality and quantity of which is actively managed by the bank for as long as it is solvent. The pool of assets backing a securitisation on the other hand, is usually a static pool which is removed from the balance sheet of the bank (resulting in regulatory capital relief for the bank<sup>11</sup>). Furthermore, covered bonds typically rank *pari passu* between themselves, whereas in a securitisation the highest credit risk is concentrated in the subordinated tranches of notes. The main differences between covered bonds and securitisation can be summarised as set out in Figure 13.1.

Figure 13.1. Main Differences Between Covered Bonds and Securitisation



10. For a description of what 'widening of spreads' means, see *supra* n. 7.

11. 'Regulatory capital relief' in short means that a bank is allowed to reduce its (supervisory) own funds (*toetsingsvermogen*), since the part of the (supervisory) own funds that was required in relation to the relevant assets as a buffer to be able to cope with potential losses in respect of such assets is no longer necessary. Own funds are relatively expensive for a bank.

That said, there is a number of similarities between covered bonds and securitisation. For example, both are used by banks as a funding tool and both are backed by assets. As a result, some of the topics which are relevant for this Chapter 13, are already addressed in Chapter 12 (*Securitisation*) of this book. To prevent overlap, this chapter will in a number of places refer to the relevant paragraphs of Chapter 12.

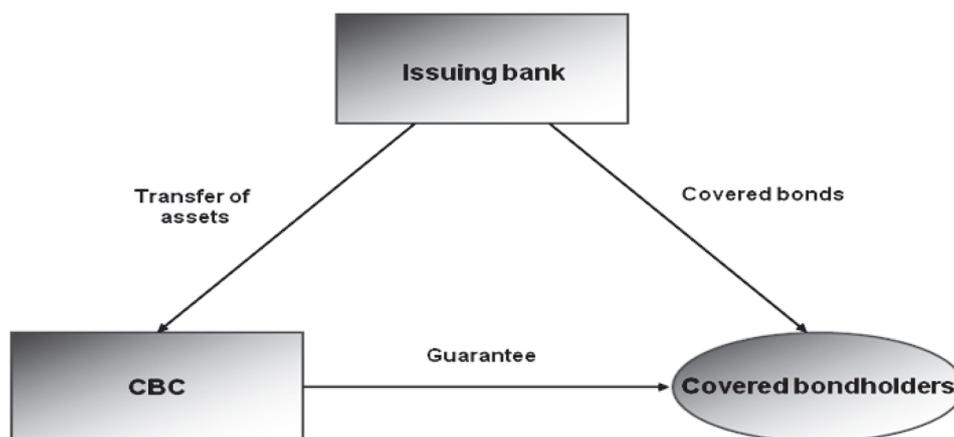
## 13.2. HOW COVERED BONDS WORK

### 13.2.1. SEGREGATED STRUCTURE

The basic elements of the Dutch covered bond structure can be visualised as set out in Figure 13.2.

In short the bank issues covered bonds to the covered bondholders and transfers cover assets to a special purpose vehicle called a covered bond company (the CBC).<sup>12</sup> The covered bonds are unsecured bonds which are guaranteed by the CBC, meaning in short that if the issuing bank defaults, the CBC will instead of the issuing bank make payments of scheduled principal and interest to the covered bondholders.<sup>13</sup> The above structure is called a ‘segregated’ structure because the

Figure 13.2. Basic Elements of Dutch Covered Bond Structure



12. For a more detailed description on special purpose vehicles generally please see para. 12.3 (*Dutch Special Purpose Vehicles*) of this book.

13. For a more detailed description of the guarantee see para. 13.2.3 (*Guarantee*) below. The guarantee is secured by a right of pledge over the assets owned by the CBC. Strictly speaking the right of pledge is unnecessary, as a right of pledge is predominantly relevant in case of a

cover assets are segregated from the issuing bank. The segregated structure needs to be distinguished from an 'integrated' structure, where the cover assets continue to be owned by the bank and no CBC is involved.<sup>14</sup> In a Dutch law integrated structure the bank would issue the covered bonds to the covered bondholders and pledge the cover assets to the covered bondholders (or a trustee acting on their behalf) as security for its payment obligations under the covered bonds.

There are mainly two reasons why Dutch covered bonds are issued under a segregated structure. Firstly, when the first Dutch Contractual Covered Bonds were being structured for ABN AMRO in 2005, investors had seen Contractual Covered Bonds from the UK only, which are issued under a segregated structure. It made sense to offer those investors something they were already familiar with and thus to stay close to the UK example.

Secondly, the segregated structure works with a transfer (*overdracht*) rather than a pledge (*verpanding*), as would be used in an integrated structure. For investors, a pledge has a number of disadvantages when compared to a transfer, including that a pledgee could be subjected to (a) a cooling-off period (*afkoelingsperiode*); and (b) a request from the liquidator to liquidate the cover assets within a reasonable term.<sup>15</sup> Such a cooling-off period or premature liquidation could disrupt the cash flows originated by the cover assets and needed for payments to the covered bondholders. Those disadvantages of a pledge when compared to a transfer are one of the reasons why following the re-introduction into Dutch law of the concept of silent assignment in 2004, a transfer structure based on silent assignment developed into the better practice for Dutch true sale securitisations over the old structure ultimately relying on a pledge.<sup>16</sup> Although the abovementioned disadvantages of a pledge could be addressed by structural solutions which could be implemented in an integrated structure, a segregated structure is more straightforward and more in line with Dutch securitisation techniques which the rating agencies, regulator, originators and investors are familiar with. In the Dutch covered bond regulation the Dutch regulator stated that it will only accept a segregated structure for covered bonds.<sup>17</sup>

When 'Dutchifying' the UK covered bond structure, one structural simplification was introduced. In the UK structure (like in a securitisation) the CBC is a

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bankruptcy of the CBC, whereas the CBC is a bankruptcy-remote entity. The main reason why the right of pledge is created in practice nevertheless is that there is generally no objection against creating it and that rating agencies, regulators and market participants prefer a belts-and-braces approach, for the unlikely scenario that the CBC goes bankrupt or the CBC (represented by its management) for any reason does not comply with its obligations under the transaction documents. For a description on creation and enforcement of security for note holders, see para. 12.8 (*Transaction Security*) of this book.

14. An example of covered bonds using an integrated structure are German *Pfandbriefe*.
15. Sections 63a and 58, respectively, of the Dutch Bankruptcy Code. For a more detailed description see also para. 12.8.4.2 (*Impact of Insolvency on Security*) of this book.
16. The old structure works with a notified assignment with postponed notification and backed by a silent pledge, as described in Ch. 12 (*Securitisation*), see *infra* n. 37.
17. See para. 13.3.4 (*Regulated Covered Bonds*) under (a) below.

central player through which all cash flows are channelled: on ‘day 1’ the issuing bank on-lends the issuance proceeds to the CBC, which the CBC in turn applies to pay the issuing bank a purchase price for the cover assets; on each subsequent payment date the principal and interest proceeds generated by the cover assets are (like in a securitisation) applied by the CBC to pay amounts of principal and interest in respect of the funding it received (in a securitisation under the notes from investors; in a covered bond structure under the loan from the issuing bank). When the Dutch structure was developed, it was felt to be somewhat synthetic to channel the cash flows through the CBC. After all, (unlike in a securitisation) in a covered bond structure (a) the CBC is only a substitute player which does not require any cash flows unless the issuing bank defaults and the guarantee is activated; and (b) the issuing bank funds its payments under the covered bonds from its general financial means and does not specifically require the proceeds generated by the cover assets to be able to pay principal or interest in respect of the covered bonds. Therefore, when the Dutch covered bond structure was developed, it was felt to be somewhat synthetic to require the issuing bank to lend monies to the CBC so as to enable the CBC to pay a purchase price back to the issuing bank. For that purpose a guarantee support agreement was introduced which made the requirement for a purchase price and the associated synthetic cash flows redundant. The guarantee support agreement allowed ABN AMRO and subsequent Dutch issuers (to date Achmea, ING, NIBC and SNS) to present a simple and transparent structure to investors.

### 13.2.2. GUARANTEE SUPPORT AGREEMENT

The guarantee support agreement is an innovative instrument which was tailor-made for Dutch covered bond structures. It is an agreement between the issuing bank and the CBC. It serves as a legal basis (*titel*) for the transfer of cover assets by the issuing bank to the CBC. The actual transfer is effectuated by way of a delivery (*levering*), which could take the form of for example an assignment (if the cover assets are registered claims such as residential mortgage receivables) or book-entry transfer (if the cover assets are book-entry securities such as government bonds).

In the guarantee support agreement the issuing bank agrees to transfer the cover assets to the CBC as consideration for the CBC issuing the guarantee and so as to enable the CBC to perform its obligations under the guarantee. In return, the CBC agrees that for as long as it is not required to make payments under the guarantee, the issuing bank may: (a) continue to collect and retain the proceeds on the cover assets; and (b) request a retransfer of cover assets as long as, following the retransfer, the CBC still has sufficient cover assets to perform its obligations under the guarantee.<sup>18</sup> If the CBC becomes obliged to make payments under the guarantee (a) the authority to collect and retain the proceeds on the cover assets

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18. For determining whether the CBC has sufficient assets from time to time, an asset cover test is run on a monthly basis, as described in more detail in para. 13.2.4 (*Cover assets*) below.

shifts to the CBC; and (b) the issuing bank will no longer be entitled to request retransfers of superfluous cover assets and will basically have no other right than to receive any remaining cash from the CBC after all covered bondholders and other senior and junior creditors of the CBC have been paid in full in accordance with the applicable priority of payments. The guarantee support agreement does not qualify as a sale and purchase, donation or exchange agreement or any other type of special agreement (*bijzondere overeenkomst*) listed in Book 7 or 7A of the Dutch Civil Code (*Burgerlijk Wetboek*; DCC). It is an agreement of its own kind (*sui generis*).

The guarantee support agreement is not invalidated by section 3:84(3) DCC,<sup>19</sup> which prohibits two types of legal acts.

Firstly, it prohibits legal acts which purport to transfer assets by way of security. The transfer of cover assets by the issuing bank to the CBC is not a transfer by way of security. Making sufficient assets available to a company so as to enable that company to perform its obligations towards third parties does not have anything to do with a security transfer. The purpose of a security transfer is to grant a creditor a right to take recourse to certain assets of its debtor with priority over other creditors of that same debtor.<sup>20</sup> The CBC is not a creditor of the bank and does not require recourse to assets of the bank. There might still be an argument to state that the guarantee support agreement is invalidated by section 3:84(3) DCC if there are ancillary circumstances from which it should be concluded that the parties' intention was to circumvent section 3:84(3) DCC.<sup>21</sup> Insofar as we are aware no such circumstances exist. Preferring a segregated over an integrated structure can in itself not serve as an ancillary circumstance from which it should be concluded that the parties intended to circumvent section 3:84(3) DCC: the segregated structure (involving the CBC as a third party co-debtor) is further removed from a security transfer than a sale and financial lease-back structure (involving only a debtor and its creditor, being the purchaser, financier and lessor of the relevant assets), against which the Supreme Court saw no principal objections in the Sogelease case.

Secondly, section 3:84(3) DCC prohibits legal acts lacking the intent to transfer the assets to the transferee. The guarantee support agreement does not lack the intent to transfer the cover assets to the CBC; its main purpose is to transfer cover assets to the CBC. The transfer enables the CBC to, should the need arise, collect proceeds on, and sell or refinance, as appropriate, the cover assets and to perform its payment obligations under the guarantee. The guarantee support agreement grants the issuing bank some contractual rights in respect of the cover assets, being the right to: (a) collect and retain proceeds; and (b) request a retransfer of superfluous cover assets, but only for as long as the CBC is not required to make payments under the guarantee. In the Sogelease case the Dutch Supreme Court confirmed that the above prohibition on legal acts which lack the intent to transfer

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19. For a different and unsustainable view, see A.F. Salomons & M.G. van 't Westeinde, *WPNR* (2008/6758).

20. Dutch Supreme Court, 19 May 1995, *NJ* 1996, 119 (Sogelease), consideration 3.4.4.

21. *Ibid.*

the assets to the transferee, does not invalidate an arrangement in which one party (in this case the CBC) owns the assets and the other party (in this case the issuing bank) has contractual rights and obligations only.<sup>22</sup>

### 13.2.3. GUARANTEE

Under the guarantee the CBC undertakes to pay to the covered bondholders amounts of scheduled principal and interest due under the covered bonds, which can be explained in more detail as follows. In first instance the issuing bank is obliged to pay amounts of principal and interest on the covered bonds. The guarantee is activated only, in short, if the issuing bank fails to pay principal or interest on the covered bonds, in which case the covered bonds will be accelerated<sup>23</sup> against the issuing bank only. As a result of the acceleration, the issuing bank will be obliged to repay the total principal amount of all covered bonds then outstanding together with all outstanding interest. As the issuing bank will be in financial difficulty by the time the covered bonds are accelerated against it, it is unlikely that the issuing bank will be able to repay all covered bonds together with outstanding interest. Should any amount of principal or interest be received from the issuing bank (or its liquidator in insolvency), then such amount will not be applied to repay principal or pay interest to the covered bondholders, but will be paid to, and added to the cover assets owned by, the CBC. The amounts so received from the issuing bank (or its liquidator in insolvency) (a) will discharge the obligation of the issuing bank in respect of the covered bonds for the equivalent of the amount received; and (b) will, like any other cash flows available to the CBC, be used by the CBC to make payments of scheduled principal and interest to the covered bondholders. The general intent is that even though the position of the issuing bank may deteriorate, the covered bondholders will continue receiving payments of principal and interest on the payment dates originally scheduled for the covered bonds. In other words, the CBC and the asset-backed guarantee are in place so as to bring the covered bonds to the finish line even if the issuing bank becomes insolvent.

Generally covered bonds provide for one bullet repayment at maturity, and not for instalment repayments of principal during the term of the covered bonds. Some covered bonds are issued with a 'soft bullet' maturity, which means that under the guarantee the CBC is permitted to extend the maturity of the covered bonds by one year. That possible extension option is available only to the CBC (and not to the issuer) and only in respect of final redemption amounts payable by the CBC (and not to payments of interest). Covered bonds without such a possible maturity extension under the guarantee are called covered bonds with a 'hard bullet' maturity.

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22. See consideration 3.6 of the Sogelease case.

23. For an explanation of what 'acceleration' of a debt means, see *supra* n. 3.

It is possible that a covered bondholder wishes to transfer its covered bonds to a transferee. In such circumstances, the transferee will together with the covered bonds wish to acquire the corresponding rights under the guarantee. Due to the independent nature of the payment obligations of the CBC under the guarantee, the guarantee qualifies as an independent payment undertaking and not as a suretyship (*borgtocht*). That means that from the perspective of the covered bondholders, the guarantee is an independent claim and not an accessory right (*afhankelijk recht*), and is unlikely to be an ancillary right (*nevenrecht*), which in turn means that the guarantee does not by operation of law follow the receivables it secures upon a transfer thereof. Such an 'automatic' transfer of the guarantee, can in the case of bearer (*toonder*) covered bonds be accomplished by ensuring that the guarantee forms an integral part of the covered bonds. For that reason the guarantee and the covered bonds provide that the rights under the guarantee (a) form an integral part of the covered bonds; (b) are of interest to a holder of covered bonds only if, to the extent that, and for so long as, it holds covered bonds; and (c) can only be transferred together with all other rights under the relevant covered bond. As a result, in case of a transfer of a covered bond to a transferee by way of a book-entry transfer (*girale overboeking*) or physical transfer of a bearer covered bond, such transfer includes the corresponding rights under the guarantee. For covered bonds which are registered (*op naam*), the rights under the guarantee are to be separately assigned, together with the corresponding rights under the relevant registered covered bonds.

#### 13.2.4. COVER ASSETS

The cover assets are owned by the CBC, but from an accounting perspective the cover assets continue to be on the consolidated balance sheet of the issuing bank, which continues to carry the credit risk of the cover assets. To date all Dutch covered bond programmes are backed by residential mortgage loans.<sup>24</sup> In addition they allow for inclusion of other types of cover assets called 'substitution' assets, meaning euro-denominated (a) cash; or (b) subject to minimum rating and maximum percentage requirements (this differs per programme), other assets eligible under the CRD to collateralise covered bonds. 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 (NIBC), German residential mortgage loans.

One of the obligations of the issuing bank is to ensure that the CBC has sufficient cover assets to be able to meet its payment obligations under the guarantee. For this purpose an asset cover test is run on a monthly basis. The asset cover test intends to calculate the ratio of the cover assets owned by the CBC to the covered bonds issued by the issuing bank. If the CBC owns

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24. For a more detailed description on the peculiarities of transferring residential mortgage loans see, for example, paras 12.4.3 (*Security*) and 12.4.4 (*Selected Legal Issues*) of this book.

insufficient cover assets, the issuing bank is obliged to transfer more cover assets to the CBC. When calculating the value of the CBC's cover assets on a monthly basis under the asset cover test, certain deductions are made so as to, among other things, account for certain risks.<sup>25</sup>

#### 13.2.5. ASSET AND LIABILITY MANAGEMENT

Under all current Dutch covered bond programmes swaps are entered into at two levels: first a total return swap at the cover pool level and then interest rate or structured swaps at covered bond issuance level. The total return swap is entered into at inception of the programme and basically swaps the different types of interest<sup>26</sup> to be received on the cover assets to one month's EURIBOR (the Euro Interbank Offered Rate). In addition, an interest rate swap or structured swap is entered into each time a series of covered bonds is issued under a programme. The interest rate/structured swap basically swaps one month's EURIBOR/euro's to the interest rate/currency payable under the relevant series of covered bonds. In cases where the issuing bank has a high credit rating, the issuing bank may opt to postpone the entering into of such interest rate and structured swaps until the occurrence of certain rating trigger events.

All Dutch covered bond programmes to date require the issuing bank to establish a reserve fund equal to one month's interest payments on the covered bonds plus certain costs and expenses for one month if the issuing bank'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 to date use either:

- (a) a pre-maturity test which is taken on each business day during the following number of months preceding the maturity of the relevant covered bonds:
  - (i) if the rating agency Standard & Poor's rates the covered bonds, six months; and/or
  - (ii) if the rating agency Moody's and/or Fitch rates the covered bonds, twelve months.

The pre-maturity test is failed if on the relevant test date the issuing bank's short term rating is or falls below P-1/F1+/A-1+. A breach of the pre-maturity test requires (x) the issuing bank to cash-collateralise covered bonds with a hard bullet maturity;<sup>27</sup> or (y) the CBC to procure alternative

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25. For example the deduction risk that applies to residential mortgage loans which are combined with an insurance policy with a capital element, as described in para. 12.4.4.2 (*Set-Off and Deduction*) of this book.

26. For example, the underlying residential mortgage loans may carry fixed and floating rates at different levels and for different interest periods.

27. For an explanation on what 'hard' and 'soft' covered bonds are, see para. 13.2.3 (*Guarantee*) above.

- remedies such as a guarantee of the issuing bank's obligations, a liquidity facility and/or a sale or refinancing of cover assets; or
- (b) the possibility of a one-year maturity extension (i.e., covered bonds with a soft bullet maturity).<sup>28</sup>

For all Dutch covered bond programmes a minimum level of over-collateralisation<sup>29</sup> is required, which is measured by applying asset percentages ranging from approximately 87.5% to 94% in the asset cover test. That translates into a minimum degree of over-collateralisation of 6.3% to 14.3% (this differs per programme).

### 13.3. SPECIFIC COVERED BOND REGULATIONS

#### 13.3.1. SECTION 22(4) UCITS DIRECTIVE

Under the UCITS Directive, a UCITS<sup>30</sup> may not invest more than 5% of its assets in transferable securities or money market instruments issued by a single issuing bank. In 1988 the UCITS Directive was amended to increase the 5% limit to 25% for investments in covered bonds. At the same time a definition of covered bonds was introduced in section 22(4) UCITS Directive:

(. . .) certain bonds (. . .) issued by a credit institution which has its registered office in a Member State and is subject by law to special public supervision designed to protect bond-holders. In particular, sums deriving from the issue of these bonds must be invested in conformity with the law in assets which, during the whole period of validity of the bonds, are capable of covering claims attaching to the bonds and which, in the event of failure of the issuing bank, would be used on a priority basis for the reimbursement of the principal and payment of the accrued interest.

Until 2008 the Netherlands knew no law that provided for '*special public supervision designed to protect bondholders*' as required by section 22 (4) UCITS Directive. That meant that Dutch issuing banks could issue Contractual Covered Bonds only and not Regulated Covered Bonds, which put them at a disadvantage to covered bond issuers from most other European countries. As will be explained in more detail below, under different areas of European financial market regulation prudential investment limits are eased if an investment is made in Regulated Covered Bonds rather than Contractual Covered Bonds.

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28. *Ibid.*

29. For an explanation of what 'over-collateralisation' means, see *supra* n. 2.

30. A 'UCITS' means an undertaking for collective investment in transferable securities (*instelling voor collectieve belegging* or *icbe*).

13.3.2. CONSULTATION PROCESS

In an effort to create a level playing field for Dutch banks, in June 2003 a working group consisting of the Dutch Bankers' Association and DNB took the initiative and sent a proposal for a Dutch covered bond law to the Dutch Ministry of Finance, together with a report comparing different covered bond regulations from other European countries. Despite external pressure from various sources the Ministry of Finance did not give Dutch covered bond regulation much priority at the time. ABN AMRO Bank N.V. decided not to await the requested regulation and issued the first ever Dutch Contractual Covered Bonds in 2005.

In or around February 2006 Dutch covered bond regulation was put back on the agenda at the Ministry of Finance, presumably fuelled by renewed external pressure and the momentum created by the consultation on English covered bond regulation that was started by the Financial Services Authority at about the same time. In those days the UK and the Netherlands were among the very few European countries that did not have specific covered bond regulation yet. In September 2006 the Ministry of Finance issued a press release announcing that covered bonds regulation would be implemented in the Netherlands, that a first draft of the regulation would be ready in the first half of 2007 and that the regulation would enter into force one year thereafter, depending on Parliament.

From April 2007 a number of working group meetings was held involving the Ministry of Finance, DNB, the Dutch Bankers' Association, issuing banks and law firms active in the covered bond market. In November 2007 the Ministry of Finance opened a public consultation with the market on a draft regulation for Dutch covered bonds (the *Regulation*). On 1 July 2008 the Regulation came into force.

13.3.3. REGULATORY FRAMEWORK

The Regulation aims to:

- provide Dutch issuing banks 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 the segregated structure, and does not recognise an integrated structure.<sup>31</sup> Under the Regulation, asset segregation takes place on the basis of the Dutch Civil and Bankruptcy Codes. The applicable statutory provisions in the Dutch Civil and Bankruptcy Codes are relatively creditor-friendly and have enabled the Ministry of Finance to take a time-efficient and principles-based approach without the need to have the Dutch Civil or Bankruptcy Code amended.

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31. Both structures are explained in para. 13.2.1 (*Segregated Structure*) above.

The Regulation is not a separate instrument but a collection of rules forming part of two layers of secondary regulation implementing the FSA:

- (a) the Decree on Prudential Rules FSA (*Besluit prudentieel toezicht Wft*); and
- (b) 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 FSA (*Regeling solvabiliteitseisen voor het kredietrisico Wft*; 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, 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 part of the European Economic Area. The 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’ cover assets. *CRD-compliant* cover assets are basically cover assets that meet the requirements of item 68 of Annex VI to the BCD (which together with the CAD constitutes the CRD).<sup>32</sup>

The relevant provisions of the Regulation and the Solvency Requirements FSA are listed in Table 13.1.<sup>33</sup>

Table 13.1. *Relevant Provisions of the Regulation and the Solvency Requirements FSA*

<i>Applicable regulation</i>	<i>Relevant sections</i>	<i>Explanatory notes</i>
Decree on Prudential Rules FSA ( <i>Stb.</i> 2006, 519)	Sections 1 (definitions of ‘registered covered bond’ and ‘covered bond’), 124a, 124b and 124c	<i>Stb.</i> 2008, 210 (the Decree Explanatory Notes)
FSA Implementing Regulation ( <i>Stcrt.</i> 2006, 230, 20)	Sections 1 (definitions of ‘offering programme’, ‘application’, ‘covered bond’ and ‘legal advisor’), 20a, 20b and 20c	<i>Stcrt.</i> 2008, 121, 10

32. It is beyond the scope of this Ch. 13 to address all requirements imposed by the CRD and the Solvency Requirements FSA on the cover assets backing Regulated Covered Bonds in detail. The applicable CRD requirements in short prescribe which types of debtor and asset are eligible and what maximum limit applies to certain types of assets. Two points to note are that the Solvency Requirements FSA erroneously (a) refer to a ‘recognised covered debt instrument’ instead of ‘registered covered bond’ in the definition of ‘covered bond’; and (b) do not refer to commercial mortgage-backed securities as eligible assets to back Regulated Covered Bonds in Annex 1 thereto.

33. In addition, s. 135(1) Decree on Conduct of Business of Financial Undertakings FSA (*Besluit gedragstoezicht financiële ondernemingen Wft*) permits higher investment limits for investments in covered bonds by UCITS.

Table 13.1. (cont'd)

<i>Applicable regulation</i>	<i>Relevant sections</i>	<i>Explanatory notes</i>
Solvency Requirements FSA ( <i>Stcrt.</i> 2006, 248, 2)	Sections 1:1 (definition of 'covered bond'), 2:38, 2:39, 2:40, 3:44(1)(c), 4:29(2), 7:8(2)(g), 8:1, 8:2 and Annex 1	<i>Stcrt.</i> 2006, 248, 2

## 13.3.4. REGULATED COVERED BONDS

The Regulation defines a covered bond<sup>34</sup> basically by prescribing six general criteria that follow from section 22(4) UCITS Directive as interpreted and implemented by the Ministry of Finance:

- (a) *it is issued by a bank*<sup>35</sup> *having its registered office in the Netherlands*. That excludes banks operating in the Netherlands on a cross-border basis (*verrichten van diensten*) or through a branch office (*bijkantoor*). Subsidiary companies of a Dutch licenced bank are not eligible to act as issuing bank, even if their obligations are guaranteed by their parent bank and they are included in the consolidated supervision on that parent bank.<sup>36</sup> Consequently, group financing companies (*financieringsmaatschappijen*) having their registered office in the Netherlands and relying on an exemption from the statutory bank licence requirement pursuant to section 3:2 FSA are not capable of issuing Regulated Covered Bonds. The issuing bank must be licenced and subject to full ongoing supervision by DNB;
- (b) *it is covered by cover assets which will be used with priority towards payment of principal and interest on the covered bonds if the issuing bank defaults*. The Regulation acknowledges that certain costs need to be made so as to ensure that the covered bondholders are fully and timely paid. The Regulation therefore allows certain proceeds of the cover assets to be applied towards certain higher ranking payment obligations of the CBC

34. Section 1 Decree on Prudential Rules FSA.

35. The UCITS Directive definition of a covered bond refers to a 'credit institution' (*kredietinstelling*) rather than a 'bank'. Under the FSA 'bank' is a more appropriate term, as 'credit institution' is a collective term covering both banks and electronic money institutions. Electronic money institutions are restricted in their activities and would never be able to issue covered bonds (see s. 3:34 FSA). In this context it should be realised that s. 22(4) UCITS Directive was created long before electronic money institutions were included in the definition of credit institution in the BCD.

36. See s. 6 of the Decree Explanatory Notes.

such as those relating to: (i) the management and administration of the cover assets; and (ii) derivative contracts.<sup>37</sup> In some European countries (such as the UK) the legislator or regulator has taken a less flexible approach towards the relevant component of section 22(4) UCITS Directive and has required that no obligation of the CBC (or its foreign equivalent) may rank senior to the payment of principal and interest on the covered bonds;

- (c) *the cover assets have been safeguarded for the benefit of the covered bondholders by way of a transfer to a CBC and a pledge to a trustee.*<sup>38</sup> The transfer may occur on a universal legal basis (*algemene titel*; such as a demerger (*afsplitsing*)) or a special legal basis (*bijzondere titel*; such as a transfer (*overdracht*) pursuant to a guarantee support agreement) and the transfer may be governed by foreign law. Instead of a right of pledge (*pandrecht*) a comparable foreign law security right may be created. Alternative ways of safeguarding the cover assets for the covered bondholders are also permitted, as long as they are approved by a ministerial regulation. However, at the time the Regulation came into effect, the Ministry of Finance and DNB seemed to oppose an integrated structure, due to the disadvantages which a pledge has compared to a transfer from the perspective of the covered bondholders;<sup>39</sup>
- (d) *the cover assets provide sufficient cover for the payment of principal and interest on the covered bonds and the cost of managing and administering the cover assets;*
- (e) *the cover assets are governed by the law of a Member State, the United States of America, Canada, Japan, the Republic of Korea, Hong Kong, Singapore, Australia, New Zealand or Switzerland; and*
- (f) *the issuing bank does not own or control the CBC or the trustee.* The CBC and the trustee must be special purpose vehicles<sup>40</sup> and may be foreign legal entities.

### 13.3.5. UCITS- & CRD-COMPLIANCE

Although the Solvency Requirements FSA contain detailed provisions on cover assets as prescribed by the CRD, the Regulation only lists the general requirements of section 22(4) UCITS Directive. The Regulation therefore introduces CRD-compliance as an option, and not as a requirement. In covered bond regulation across Europe that is a novel feature. It allows issuing banks of (and thus investors in)

37. See the Decree Explanatory Notes, under item b of the covered bond definition.

38. A 'trustee' is in short a party representing and looking after the interests of the covered bondholders vis-a-vis the issuing bank. In the Netherlands it usually takes the form of a special purpose foundation (*stichting*).

39. For a description of these disadvantages, see para. 13.2.1 (*Segregated Structure*) above.

40. For an information source on special purpose vehicles, see *supra* n. 12.

Regulated Covered Bonds the flexibility to choose whether they wish to issue (or invest in) Regulated Covered Bonds which are either:

- (a) compliant with the UCITS Directive (*UCITS-compliant*); or
- (b) both UCITS-compliant and CRD-compliant (*UCITS- & CRD-compliant*).

The above novel 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:

- (a) a loan is only eligible to be transferred to the CBC if its principal amount did not exceed 125% (subject to some exceptions in some programmes; the *Eligibility Percentage*) of the value of the mortgaged property at origination; and
- (b) once a loan forms part of the cover assets of the CBC, the maximum value attributed to it in the asset cover test 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: (i) the relevant LTV Cut-Off Percentage is 80%; and (ii) 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. The 30 excess value of the loan would serve as extra credit enhancement. The LTV Cut-Off Percentage applied to Dutch residential mortgage loans is:
  - (i) 80% in Dutch covered bond programmes which are designed to be backed by CRD-compliant cover assets (ABN AMRO, ING and SNS);
  - (ii) 125% in Dutch covered bond programmes which are not designed to be backed by CRD-compliant cover assets (Achmea and NIBC); and
  - (iii) 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*).

To date under the Dutch covered bond programmes:

- (a) the Eligibility Percentage is applied to the foreclosure value at origination; and
- (b) the LTV Cut-Off Percentage is applied to the market value of the mortgaged property at the relevant time. The market value is in turn calculated at 85%–90% (this differs per programme) of the applicable foreclosure value at origination, subject to indexation. As to indexation: (i) if prices go

up, the property value is increased by 85%–100% (this differs per programme) of the increase; and (ii) if prices go down, the value is reduced by 100% of the decrease.

### 13.3.6. REGISTRATION BY DNB

Before a Dutch covered bond qualifies for the regulatory benefits available to Regulated Covered Bonds, it needs to be registered by DNB. For that purpose the issuing bank will need to demonstrate to DNB that the bonds qualify as covered bonds within the meaning of the Regulation by submitting documents showing that the following requirements are met:

- (a) the requirements set out in paragraph 13.3.4 (*Regulated Covered Bonds*) above and paragraph 13.3.7 (*Ongoing administration and reporting obligations*) (a) and (b) below<sup>41</sup> are met;
- (b) the covered bonds must have a credit rating of at least AA- (Fitch or S&P) or Aa3 (Moody's);<sup>42</sup>
- (c) there must be a healthy ratio between on the one hand the programme/issuance amount and on the other hand (i) the value of the cover assets; (ii) the value of the remaining assets of the issuing bank eligible and freely available for addition to the cover assets; and (iii) the consolidated balance sheet of the issuing bank (the latter to protect other stakeholders);<sup>43</sup> and
- (d) the issuing bank must have solid and effective strategies and procedures 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.<sup>44</sup>

To date the ABN AMRO, ING, NIBC and SNS covered bond programmes are registered by DNB. The register is available on-line and can be found at <[www.dnb.nl/openboek/extern/id/en/all/41-194648.html](http://www.dnb.nl/openboek/extern/id/en/all/41-194648.html)> (click on: Searching in the register). The DNB register indicates whether the relevant covered bonds are registered as UCITS-compliant or UCITS- & CRD-compliant. Dutch covered bonds which are not registered are Contractual Covered Bonds and are neither UCITS-compliant nor CRD-compliant.

DNB will notify the Commission of the European Communities of each covered bond programme registered by it, for inclusion of the relevant covered bonds in the register maintained by the European Commission under section 22(4) UCITS Directive.<sup>45</sup>

41. Section 20a(1) FSA Implementing Regulation.

42. Section 20a(2)(a) FSA Implementing Regulation.

43. Section 20a(2)(b) FSA Implementing Regulation.

44. Section 20a(2)(c) FSA Implementing Regulation.

45. For the register maintained by the European Commission, see <[http://ec.europa.eu/internal\\_market/investment/legal\\_texts/instruments\\_en.htm](http://ec.europa.eu/internal_market/investment/legal_texts/instruments_en.htm)>.

13.3.7. ONGOING ADMINISTRATION AND REPORTING OBLIGATIONS

Once a Dutch covered bond programme is registered by DNB, the issuing bank will have ongoing administration and reporting obligations towards DNB:

- (a) it must keep a record of all covered bonds issued and of all assets serving as cover assets;<sup>46</sup>
- (b) it must demonstrate at least quarterly<sup>47</sup> that the covered bonds continue to meet the criteria summarised in paragraph 13.3.4 (*Regulated Covered Bonds*) above, by granting DNB access to the records referred to in (a) above and for instance audit reports, credit rating reports<sup>48</sup> and reports regarding the cover assets.<sup>49</sup> This is without prejudice to the general authority of DNB to request information from the issuing bank on the basis of its regular banking supervision powers;<sup>50</sup>
- (c) it must demonstrate at least annually to DNB that it complies with the requirement set out in paragraph 13.3.6 (*Registration by DNB*) under (d) above;<sup>51</sup>
- (d) annually, within six months of the close of its financial year, it must submit to DNB the annual financial statements and the annual report of the CBC;<sup>52</sup>
- (e) it must immediately notify DNB if, for as long as any covered bond is outstanding (i) changes occur in respect of the data, transaction documents or other submitted documents, as a result of which the outstanding covered bonds are or will no longer be compliant with the requirements for registration; or (ii) significant changes are made in the covered bond programme or the conditions of the covered bonds;<sup>53</sup> and
- (f) before it issues any further covered bonds, (i) it must ascertain that the requirements for registration are complied with<sup>54</sup> (there is no need to have the further covered bonds assessed by DNB); and (ii) if the ratio between the total nominal value of the covered bonds and the consolidated balance sheet total of the issuing bank increases beyond what DNB had determined to be a healthy ratio, the issuing bank must demonstrate to DNB that the new ratio can be considered healthy.<sup>55</sup>

46. Section 124c(a) Decree on Prudential Rules FSA.

47. Section 124c(b) Decree on Prudential Rules FSA in conjunction with s. 20c(1)(a) FSA Implementing Regulation.

48. Section 124c(b) Decree on Prudential Rules FSA.

49. Section 20c(1)(a) FSA Implementing Regulation.

50. Section 1:74 FSA.

51. Section 20c(1)(b) FSA Implementing Regulation.

52. Section 20c(2) FSA Implementing Regulation.

53. Section 20c(3) FSA Implementing Regulation.

54. Section 20b(1) FSA Implementing Regulation.

55. Section 20b(2) FSA Implementing Regulation.

13.3.8. DEREGISTRATION

If the covered bonds no longer meet the requirements set by the Regulation or if the issuing bank 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 issuing bank, which may be disclosed by DNB in its register. DNB is entitled to strike the registration of a covered bond.<sup>56</sup> In practice it is not very likely that DNB would ever exercise its deregistration authority. Apart from verbal assurance this is confirmed by the Decree Explanatory Notes, which in short state:

- (a) that deregistration will only occur (i) after due consideration of the interests of the issuing bank and the covered bondholders; and (ii) in the exceptional circumstance that DNB's supervision is no longer in the interest of the issuing bank and no longer grants protection to covered bondholders; and
- (b) that the interests of the issuer and the covered bondholders include that the registration and supervision be maintained.<sup>57</sup>

In the event of cancellation of the registration by DNB, DNB will notify the Commission of the European Communities without delay and publish the same on its website immediately.<sup>58</sup>

13.4. SOME BENEFITS OF REGULATED COVERED BONDS

13.4.1. ECB MONETARY POLICY OPERATIONS

As Dutch Regulated Covered Bonds are UCITS-compliant, they receive special treatment from the ECB in determining their eligibility for monetary policy operations (such as the marginal lending facility to obtain overnight liquidity from national central banks), including:

- (a) they are eligible even where the bank posting the covered bonds as collateral is the issuing bank (or has 'close links' with the issuing bank or the guarantor of the covered bonds). This means for example that a Dutch bank wishing to borrow from DNB may use its own UCITS-compliant Regulated Covered Bonds as collateral (informal assurance suggests that CRD-compliance is currently not required and that 'own' Contractual Covered Bonds will not be accepted);
- (b) they need not be admitted to trading on a regulated market (as defined in the Markets in Financial Instruments Directive (2004/39/EC)); and

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56. Section 124b(3) Decree on Prudential Rules FSA.

57. Page 14 of the Decree Explanatory Notes.

58. Section 124b(3) Decree on Prudential Rules FSA.

- (c) unlike other asset-backed securities:
- (i) they are not eligible for an exemption from the general rule that debt instruments must have a fixed, unconditional principal amount;
  - (ii) they may be backed by credit linked notes or similar claims resulting from the transfer of credit risk by means of credit derivatives; and
  - (iii) they are exempt from certain true sale requirements and credit quality thresholds. However, these exemptions are of lesser relevance for Dutch UCITS-compliant Regulated Covered Bonds because the Regulation requires a segregated structure as well as a credit rating of at least AA-/Aa3.

#### 13.4.2. REGULATORY

It depends on the type of investor whether investing in a certain category of Dutch Regulated Covered Bonds provides regulatory special treatment, as summarised in Table 13.2.

*Table 13.2. Special Regulatory Treatment of Investments in Dutch Regulated Covered Bonds*

<i>Dutch RCB category</i> → <i>Type of investor</i> ↓		<i>UCITS-compliant</i>	<i>UCITS- &amp; CRD-compliant</i>
UCITS and insurance companies		Higher investment limit	Higher investment limit
Banks and investment firms using:	Standardised Approach	None	– Exemption from large exposure limit – Lower risk-weighting
	Foundation IRB Approach	None	– Exemption from large exposure limit – Lower loss given default value
	Advanced IRB Approach	None	Exemption from large exposure limit

This can be explained in more detail as follows:

- (a) *Higher investment limits/exemption from large exposure limit.* To avoid that they have ‘too many eggs in one basket’ (i) banks and investment firms may not incur an exposure in excess of 25% of their own funds

(*toetsingsvermogen*)<sup>59</sup> to a single counterparty or a group of connected counterparties; (ii) insurance companies may not invest more than 5% of their total gross technical provisions in investments<sup>60</sup> issued by a specific issuer or in loans to a specific borrower,<sup>61</sup> taken together; and (iii) UCITS may not invest more than 10% of their assets in securities issued by the same issuer.<sup>62</sup> However, if the investments/exposures regard Regulated Covered Bonds, the exposures of the banks and investment firms are exempted and the limits for insurance companies and UCITS are raised to 40% and 25%, respectively;<sup>63</sup> and

(b) *Lower risk-weighting/lower loss given default value.* Banks and investment firms are required to have sufficient (supervisory) own funds (*toetsingsvermogen*) in relation to the size of their liabilities and the nature and extent of their business risks.<sup>64</sup> In relation to credit risk,<sup>65</sup> in short, banks and investment firms are currently required to have own funds equal to at least 8% of the sum of the amount of the risk-weighted assets<sup>66</sup> (*naar risico gewogen activa*) and off-balance-sheet items<sup>67</sup> of all their business activities.<sup>68</sup> In calculating the amount of the risk-weighted assets, banks and investment firms can apply one of three approaches:

- (i) the Standardised Approach which is generally used by the smaller and some medium-sized banks and investment firms. Under the Standardised Approach senior unsecured exposures to issuing banks that have been assigned a credit rating of AA- (Fitch or S&P) or Aa3 (Moody's) are given a risk-weight of 20%.<sup>69</sup> However, if those exposures relate to Regulated Covered Bonds issued by those banks, a risk-weight of 10% applies;<sup>70</sup> or
- (ii) (subject to permission by DNB and depending on the level of sophistication of the relevant bank or investment firm), the Foundation

59. Section 102(1) Decree on Prudential Rules FSA.

60. As referred to in s. 122b(1)(a) under 1 and 3 Decree on Prudential Rules FSA.

61. Section 123(3) Decree on Prudential Rules FSA.

62. Section 134(1) Decree on Conduct of Business of Financial Undertakings.

63. Section 7:8(2)(g) Solvency Requirements FSA (only if an over-collateralisation applies), s. 124a Decree on Prudential Rules FSA and s. 135(1) Decree on Conduct of Business of Financial Undertakings, respectively.

64. The idea being that they are then better able to deal with unfavourable (market) developments.

65. The risk of a loss due to default of payment.

66. Including loans (either secured or not), securities (including covered bonds, RMBS, equity shares and participations) and tangible assets.

67. Including guarantees, credit derivatives, acceptances, asset sale and repurchase agreements and outright forward purchase agreements.

68. Section 60(1)(a) Decree on Prudential Rules FSA.

69. Section 2.2.6 of the Solvency Requirements FSA.

70. Section 2:40(a) Solvency Requirements FSA. Under s. 2:39(b) Solvency Requirements FSA covered bonds meeting the definition of s. 22(4) UCITS Directive (i.e., UCITS-compliant Regulated Covered Bonds) and issued before 31 Dec. 2007 are also eligible for the preferential treatment until their maturity.

## *Covered Bonds*

Internal Ratings Based (IRB) Approach or the Advanced IRB Approach. Under the Foundation IRB Approach and the Advanced IRB Approach the amount of the risk-weighted assets may be calculated by using own internal estimates of the probability of default (PD).<sup>71</sup> However in respect of exposures to banks the loss given default (LGD) value, which is one of the other input parameters for this calculation, is a given amount if the Foundation IRB Approach is used. Whereas for example a senior exposure without eligible collateral is assigned an LGD value of 0.45, Regulated Covered Bonds (covered by specified assets) are assigned an LGD value of 0.1125.<sup>72</sup>

A further regulatory special treatment which is not reflected in the above diagram, is available to CRD-compliant Regulated Covered Bonds in the context of banks and investment firms entering into repurchase transactions (repo's) with the issuing bank. If the issuing bank posts its own covered bonds as collateral under the repo, then such covered bonds only 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 bank as its repo counterparty if such covered bonds are CRD-compliant.<sup>73</sup>

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71. Section 69 of the Decree on Prudential Rules FSA.

72. Under the grandfathering provision in s. 8:2 Solvency Requirements FSA this waiver is given in respect of the default LGD value of 0.125 provided in s. 3:44(1)(c) Solvency Requirements FSA until 31 Dec. 2010.

73. Section 4:29(2) Solvency Requirements FSA.