

## ISSUER COMMENT

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## NORD/LB Luxembourg S.A. Covered Bond Bank

No-deal Brexit would cast doubt over covered bondholders' priority rights to UK cover pool assets

### Summary

A no-deal Brexit would be credit negative for Nord/LB Luxembourg's (NORD/LB CBB, Baa2(cr) on review for upgrade) covered bonds (Aa3 on review for upgrade), because there would be a heightened risk that NORD/LB CBB's unsecured creditors could access the UK assets in the cover pool if the bank became insolvent, threatening covered bondholders' priority right under Luxembourg's covered bond law.

- » **A no-deal Brexit could affect 20% of NORD/LB CBB's cover pool.** In the event of a no-deal Brexit, NORD/LB CBB's UK cover pool assets would be exposed to additional legal risks compared to cover pool assets in the European Economic Area (EEA). If the bank became insolvent, the UK assets could be subject to separate insolvency proceedings in the UK. This raises the possibility that unsecured creditors could circumvent covered bondholders' priority right under Luxembourg's covered bond law and gain access to the UK assets. Twenty percent of NORD/LB CBB's cover pool assets are UK assets.
- » **Mitigating factors would limit risk in no-deal Brexit.** NORD/LB CBB has limited external creditors, which makes it less likely that there would be UK insolvency proceedings. NORD/LB CBB's covered bond programme also has substantial over-collateralisation (OC) to protect covered bondholders, while NORD/LB CBB would consider setting up trust structures to shield UK assets from NORD/LB CBB's creditors. It is also possible that in the future, the UK and the European Union (EU) agree arrangements for dealing with cross-border bank insolvencies that offer a similar level of legal certainty as the current EEA-wide framework.

## A no-deal Brexit could affect 20% of NORD/LB CBB's cover pool

A no-deal Brexit would be credit negative for NORD/LB CBB's covered bonds, because there would be a heightened risk that NORD/LB CBB's unsecured creditors could access the UK assets in the cover pool if the bank became insolvent, threatening covered bondholders' priority right under Luxembourg's covered bond law. Twenty percent of NORD/LB CBB's cover pool assets are UK assets.

Currently, if NORD/LB CBB became insolvent, insolvency proceedings would be opened in Luxembourg and not any other EEA country. This is because under the EEA-wide framework for the winding-up of banks,<sup>1</sup> the authorities of a bank's home member state have exclusive control of the winding-up of the bank and its branches across the EEA. Any action they take is automatically recognised throughout the EEA and there is a prohibition on separate proceedings elsewhere in the EEA. If NORD/LB CBB became insolvent, the UK cover pool assets would fall within the insolvency proceedings in Luxembourg, with no possibility of separate UK proceedings, and a Luxembourg court would be bound to give effect to covered bondholders' priority right under Luxembourg's covered bond law.

In the event of a no-deal Brexit, the UK assets in NORD/LB CBB's cover pool would be exposed to additional legal risks compared to EEA cover pool assets. This is because covered bondholders' priority right under Luxembourg's covered bond law is not as well protected for non-EEA assets as it is for EEA assets (this is also the case for other European covered bond laws). In the event of a no-deal Brexit, unsecured creditors could try to access the UK cover pool assets by way of UK enforcement proceedings or separate UK insolvency proceedings, raising the possibility that unsecured creditors could circumvent covered bondholders' priority right under Luxembourg's covered bond law and gain access to the UK assets. This is because under draft legislation published by the UK Treasury to address a no-deal Brexit,<sup>2</sup> the UK would fall outside the EEA-wide framework, giving rise to the possibility of separate insolvency proceedings in the UK.

## Risks recede if no-deal Brexit is avoided

If the withdrawal agreement proposed by the UK government was adopted by the UK parliament, thereby avoiding a no-deal Brexit, this risk to covered bondholders' priority right to assets in the UK would not arise during the transition period, which would run until the end of 2020. This is because the current EEA-wide framework for the winding-up of banks would continue to apply. After the transition period, the situation would depend on the outcome of negotiations regarding the future relationship between the UK and the EU.

Alternatively, if the period under Article 50 of the Treaty on the European Union was extended, the risk described above would not arise because the UK would still be part of the EU. It is unclear at this point what the situation would be after any extension period ends.

## Mitigating factors would limit risk in no-deal Brexit

In the event of a no-deal Brexit, a number of mitigating factors would limit the risks for NORD/LB CBB's covered bondholders if the bank became insolvent.

Firstly, NORD/LB CBB currently has limited external creditors other than covered bondholders. This makes it less likely that unsecured creditors would try to access the UK cover pool assets. For example, the cover pool does not currently include any swaps with external providers. However, this situation could change in the future. It is possible, for instance, that cover pool or non-cover pool swaps could be entered into in future with external counterparties, including counterparties from the UK.

Furthermore, NORD/LB CBB would in the future consider setting up trust structures over its UK cover pool assets, potentially providing high legal certainty that the UK assets would be shielded from competing unsecured creditors. Trust structures have already been tested in a covered bond context in other countries. For example, before the current EEA-wide framework for the winding-up of banks was in place, trust structures were used to safeguard UK assets for German covered bondholders.

In addition, NORD/LB CBB's covered bond programme has substantial overcollateralisation (OC), which provides protection for covered bondholders. As of 31 December 2018, NORD/LB CBB's cover pool included €1 billion of UK assets, accounting for 20% of the €5.4 billion cover pool, which backs total outstanding covered bonds of €4.4 billion. Even in a worst-case scenario where all UK

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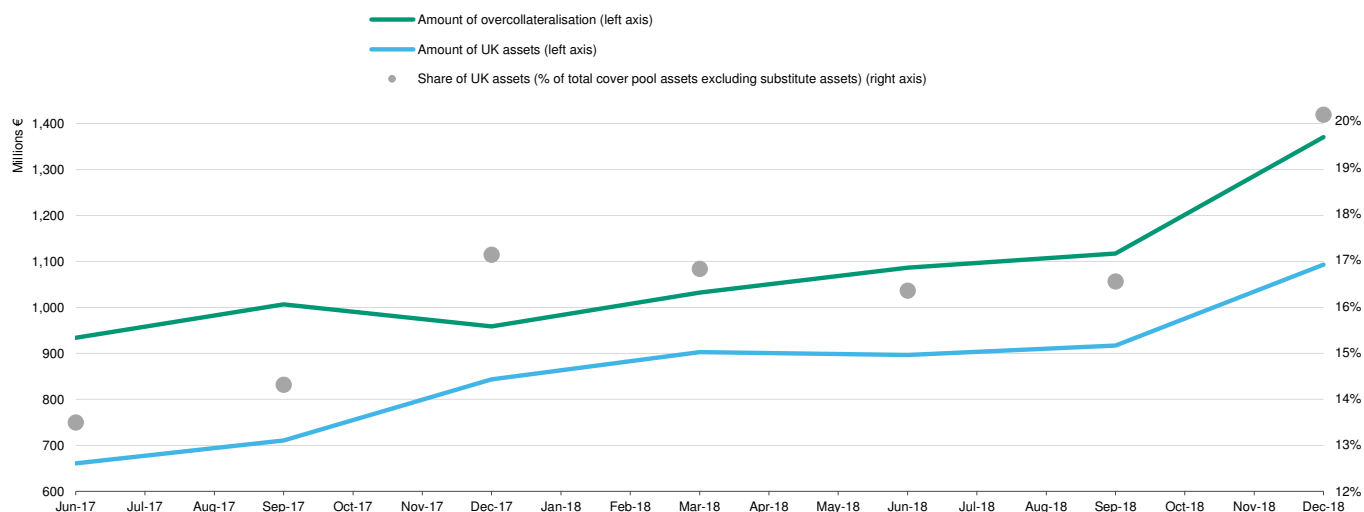
assets are lost to unsecured creditors, which we think is unlikely, the covered bonds would still be fully backed by cover pool assets on a nominal basis.

Finally, even in a no-deal scenario, it is possible the UK and the EU agree arrangements for dealing with cross-border bank insolvencies that provide a similar level of certainty as the current framework, including as to the effect of the priority rights under an EU covered bond law on cover pool assets in the UK. This could substantially remove the risk that the unsecured creditors of an EU covered bond issuer attempt to access cover pool assets in the UK (and vice versa).

Exhibit 1

### NORD/LB CBB covered bonds have substantial OC

#### Share of UK assets and OC levels for NORD/LB CBB covered bonds programme



Source: Issuer data, Moody's Investors Service

## Endnotes

- 1 [Credit Institutions \(Reorganisation and Winding Up\) Directive, implemented in the UK by the Credit Institutions \(Reorganisation and Winding Up\) Regulations 2004](#)
- 2 [Credit Institutions and Insurance Undertakings Reorganisation and Winding Up \(Amendment\) \(EU Exit\) Regulations 2018](#)

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