NautaDutilh advises on innovative ING - Dutch State deal

Illiquid assets back-up facility may lead the way

Introduction

NautaDutilh has advised Dutch banking giant ING on a Dutch State illiquid assets back-up facility that closed on 31 March 2009. This transaction distinguishes itself from other recent government rescue operations because of its innovative structure. The plan allows ING to take a large portion of its 'bad' assets off its balance sheet, as a result of which no further impairment needs to be taken for further changes in the market value of these assets. On the other hand the Dutch State's acquisition of an 80% interest in ING's Alt-A bond portfolio does not increase the Dutch State national debt.

The NautaDutilh team was led by partners Michaëla Ulrici, Erik Vermeulen and Walter Schellekens. Over a period of several months, the team has intensively been involved in structuring this challenging transaction which is the first of its kind.

Alt-A portfolio

The Dutch State's loan guarantee scheme involves ING's portfolio of securities backed by residential Alt-A mortgages. ING acquired a large portfolio of Alt-A notes due to regulatory requirements when expanding its operations in the U.S.

Alt-A ('Alternative A-paper') is a type of U.S. mortgage that is considered riskier than prime (A-paper) home loans, and less risky than the subprime category. Alt-A interest rates therefore tend to be between those of prime and subprime home loans. Alt-A mortgages are generally used by people with better credit scores. These homebuyers are granted loans with little or no verification of income, earning the Alt-A mortgages the doubtful title "liar loans". The loans were very popular with the self-employed and buyers seeking investment property rather than a home to live in. These specifics of Alt-A mortgages caused them to be prone to defaults when the credit boom came to an end.

The credit crunch and the general loss of confidence in U.S. mortgages caused the market value of ING's Alt-A portfolio to tumble. In addition, the rising default rates on the related mortgages triggered rating downgrades on a large amount of the Alt-A notes. This in turn imposed substantially higher capital requirements on ING. On a more general note, the uncertainty about future write-downs proved to be detrimental to market confidence in ING's balance sheet.

Dutch State to the rescue

For banks to recover from the credit crunch, they need to clear their balance sheet of 'toxic' assets such as Alt-A bonds. However in the current market it proves to be extremely challenging to find counterparties that have the liquidity and willingness to acquire such assets. Governments and central banks are very much involved and even pressurised by the financial world to assist in this. Nevertheless, they are obviously not keen on further rise in already increasing national debt.

Contrary to the current aura of doom and gloom around U.S. mortgages, ING's Alt-A bonds portfolio performs substantially better than suggested by its market value. Even when using very severe stress tests, the Alt-A bonds are still likely bring up 90% of their par value according to the valuations made by the Dutch State's adviser. This is substantially higher than the current market value of the same bonds, which is around 65% of the original value. The illiquid assets back-up facility aims to recognise the true value of ING's Alt-A portfolio based on its actual performance.

Terms illiquid assets back-up facility

On 26 January 2009, the Dutch State and ING reached an agreement on the term sheet for the illiquid assets back-up facility. Under the transaction, ING would be able to take 80% of the Alt-A portfolio of its balance sheet. The support to be provided by the Dutch State is structured as a guarantee rather than a purchase of the assets, so that the national debt remains unaffected. After this agreement in principle was reached, it was up to the advisers to work out the terms of this unique and challenging structure. The transaction closed just before the end of the first quarter of 2009, on 31 March 2009.

The key to the ING illiquid assets back-up facility is that it separates the legal and economic ownership of the Alt-A portfolio. First, the Alt-A portfolio was transferred through a participation structure under US law to a Dutch group entity of ING. This transfer qualifies as a 'true sale' under US GAAP and leads to de-recognition under IFRS. Subsequently, the Dutch State acquired 80% of the beneficial interests in this approx. EUR 28 billion Alt-A portfolio through the Dutch law governed illiquid assets back up facility, meaning that it participates in 80% of any results of the portfolio. This risk transfer is priced at a discount of 10% of the par value. ING remains the legal owner of 100% of the securities and will remain exposed to 20% of any results on the portfolio. The transfer to the Dutch State qualifies from a U.S. law perspective as a 'true sale' and therefore leads to de-recognition under IFRS. 80% of the Alt-A portfolio is replaced by receivables against the Dutch State, enabling ING to take this proportion of the portfolio off its balance sheet.

As the Dutch State was not prepared to increase its national debt, it was not willing to accept a proprietary interest in the Alt-A portfolio. It only has contractual rights vis-a-vis ING to receive amounts under the illiquid assets back-up facility. In exchange, the Dutch State makes periodic payments.

Legal challenges

The innovative nature of this transaction poses a number of interesting legal challenges. As U.S. securities are brought into the Dutch legal sphere, a substantial number of conflict of law questions need to be resolved. Due to the fact that the portfolio was held by multiple U.S. ING entities, the transaction consists of an internal (U.S. law governed) part and an external (Dutch law governed) part. This accommodates the Dutch State's desire to deal directly with only one Dutch counterparty. Payments are made through a bankruptcy-remote Dutch law collection foundation so that the Dutch State is able to make and receive single periodic payments.

For the assets to be qualified off-balance sheet, IFRS requires that the cash flows between ING and the Dutch State be independent. However given that the Dutch State support is structured as a guarantee, the Dutch State needs to have net exposure (i.e. exposure to actual results) rather than gross exposure on the assets. This also raised a number of legal issues in order to meet the accounting principles while protecting the interests of both ING and the Dutch State, including a security structure.

Conclusion

The ING - Dutch State illiquid assets back-up facility is the first government-supported transaction that enables a bank to take 'toxic' assets of its balance sheet under a guarantee. Various challenging legal issues have been resolved in this innovative structure that meets the interests of both ING and the Dutch

State. In other jurisdictions, this may provide a solid solution to banks facing similar issues with their mortgage-backed securities portfolios.

NautaDutilh
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