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Dutch plan for ING could be influential

BANKS

News Analysis

The move could serve as something of a template for other banks, writes Peter Thal Larsen

Middle road: the deal between ING and the Dutch government has received heavy criticism from politicians AFP

As governments around the world discuss the best way to remove risky assets from banks' balance sheets, the Dutch government's agreement with ING, announced last month, has received relatively little attention.

But the plan, which removed a $39bn portfolio of mortgage-backed securities from the Dutch banking and insurance group's balance sheet, could serve as something of a template.

The debate about how the state can best tackle bad loans has tended to split between two options: either governments buy risky assets from banks, or they provide insurance against future losses.

The Dutch deal, however, combines the two.

The deal was crafted in response to a very specific problem. When expanding its online savings arm in the US in recent years, ING acquired a large portfolio of mortgage-backed securities in order to comply with local regulations. These bonds were backed by Alt-A mortgages, a type of loan offered to homebuyers with unusual circumstances, such as the self-employed.

When the credit crisis struck, the bonds' market value plunged.

More recently, rising default rates on Alt-A mortgages have prompted ratings agencies to downgrade thousands of the bonds.

This presented ING with a series of problems. Even though it did not have to recognise the bonds' reduced market value immediately it would have to do so as soon as it became clear they would not pay out in full.

At the same time, the downgrades meant ING had to hold much more capital against the bonds. Third, uncertainty about future losses undermined market confidence in ING's balance sheet, even after it received a €10bn ($14bn) capital injection from the Dutch state last year.

The government hired **Dynamic Credit**, a New York-based company specialising in structured credit, to analyse ING's portfolio.

Dynamic Credit's 28 staff spent four weeks modelling the cash flows on the 600,000 mortgages supporting the bonds.

They then subjected the portfolio to severe stress tests: the central case assumed US house prices will decline by a further 10 per cent, while prices in Florida and California will lose 50-60 per cent of their value from the peak.

The analysis threw up some surprising conclusions. Even in a severe downturn, the bonds were likely to pay out 90 per cent of their original value, compared with a market price of about 65 per cent.

The government and ING came up with a deal whereby the state took over 80 per cent of the portfolio at 90 per cent of its face value. Though ING retains nominal ownership of the bonds, international accounting standards classify the deal as a sale, freeing up capital and boosting its shareholders' equity.

"We have effectively given the bond the characteristics of a loan and thereby strengthened the capital position and cash-flows," says Koos Timmermans, ING's chief risk officer.

However, as the Dutch government does not have to issue bonds to fund the deal, it does not boost the national debt.

"For ING it's a true sale in economic terms, but for the government it's not a purchase," says Tonko Gast, a Dutchman who is co-founder of **Dynamic Credit**.

The deal has been criticised by Dutch politicians and rival bankers for being too generous to ING. But Wouter Bos, the Dutch finance minister, said in a submission to parliament that if the bonds performed as expected the government would make a profit of $2bn. In the worst-case scenario, the government would lose just $600m.

In the debate about bad banks and insurance schemes, ING's plan offers a middle road.

Given that many other banks around the world have bonds backed by Alt-A mortgages, it may be explored elsewhere.

Indeed, such a plan could work with any assets where the underlying cash flows offer some reassurance about their future value.

However, the Dutch approach will probably not work with the most risky debt securities, such as those backed by subprime mortgages, where recovery hopes are slim.

"This can be replicated with assets that have very strong recoveries," says Mr Gast. "You can't do it with assets that evaporate."

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